

# Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of *Respondeat Superior* Liability Under Section 10(b)

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*The common law doctrine of respondeat superior provides that a principal is liable for its agents' unauthorized torts committed within the scope of employment. Until recently, respondeat superior liability had been generally applied in section 10(b) actions under the Securities Exchange Act of 1934. However, several courts and commentators now believe that the Supreme Court's recent decision in Central Bank of Denver—that no aiding and abetting cause of action exists under section 10(b)—means that respondeat superior liability cannot survive either. This Article argues that imposition of respondeat superior liability for violations of section 10(b) remains consistent with Congress's intent in enacting the statute. The plain words of the statute, which define "person" to include a company, which can be liable only on agency principles, clearly indicate that Congress assumed that common law's respondeat superior liability would apply under section 10(b). Respondeat superior liability promotes market efficiency and ensures that companies will use care in selecting and monitoring employees. Courts should continue to apply respondeat superior liability under section 10(b) in order to foster consistency among securities statutes.*

*"We have got to keep in mind all the time the people who purchased these stocks and securities and who have lost everything."*<sup>1</sup>

*"After all, I can only repeat, it is a principle that runs all through the law that we are responsible for the acts of our agents."*<sup>2</sup>

*"[T]here is now a consensus among those Americans who think about tort law that vicarious liability is an essential element in the tort system. Any idea of*

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<sup>1</sup> *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong. 9124 (1933) [hereinafter *Federal Securities Act Hearings*] (statement of Huston Thompson, a drafter of the original bill).

<sup>2</sup> *Id.* at 122 (statement of Ollie N. Butler, Dep't of Commerce). These hearings concerned the "Thompson Bill." See H.R. 4314, 73d Cong. (1933). Although the Thompson Bill was later discarded and did not provide the basis for either the 1933 or the 1934 Acts, it is clear that the Senators and Representatives who debated the bills that were eventually enacted into law were well versed regarding *respondeat superior*.

*repealing vicarious liability would seem to us preposterous, inconceivable.*"<sup>3</sup>

Over the past twenty years commentators and courts have carried on a running debate regarding whether *respondeat superior* liability should be recognized under the most important of all federal securities law liability provisions, section 10(b)<sup>4</sup> and Rule 10b-5<sup>5</sup> of the Securities Exchange Act of 1934. Although most commentators argued against recognition of such liability on grounds that the 1934 Act's provision in section 20(a)<sup>6</sup> for "controlling

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<sup>3</sup> Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1745, 1767 (1996) (expressing some doubts, nonetheless, about the persuasiveness of the rationales offered for such liability).

<sup>4</sup> 15 U.S.C. § 78j(b) (1994) [hereinafter section 10(b)]. This section provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

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To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

*Id.*

<sup>5</sup> 17 C.F.R. § 240.10b-5 (1997) [hereinafter Rule 10b-5]. This Rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

<sup>6</sup> 15 U.S.C. § 78t(a) (1994) [hereinafter section 20(a)]. Section 20(a) provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person

person" liability is the sole proper means of imposing secondary liability,<sup>7</sup> the lower courts eventually joined nearly unanimously in the view that *respondeat superior* liability should be recognized under the implied cause of action of section 10(b) and Rule 10b-5.<sup>8</sup> The Supreme Court upset this apple cart in 1994

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to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

*Id.*

<sup>7</sup> See William J. Fitzpatrick & Ronald T. Carman, *Respondeat Superior and the Federal Securities Laws: A Round Peg in a Square Hole*, 12 HOFSTRA L. REV. 1, 36 (1983) ("[R]espondeat superior should not be available to either civil litigants or the [SEC] in actions which allege violations of the federal securities laws."); James Duggan, Note, *The Brooding Omnipresence of the Federal Common Law: The Evisceration of the Controlling Persons Provisions of the Federal Securities Acts*, 50 FORDHAM L. REV. 472, 488 (1981) (controlling person provisions are the only legitimate means of imposing secondary liability under the federal securities laws); Dennis H. Johnston, Note, *Vicarious Liability of Controlling Persons Under the Securities Acts*, 11 LOYOLA L.A. L. REV. 151, 181 (1977) (controlling person provisions have supplanted common law agency theories); Douglas A. Marshall, Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 CAL. W. L. REV. 152, 173 (1979) (exclusivity of section 20(a) is consistent with legislative intent and policy); Margot A. Metzner, Note, *The "Controlling Persons" Liability of Broker-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L. J. 824, 843 ("controlling person provisions . . . have excluded agency liability"); Diana L. Reed, Note, *Third Circuit Adopts Limited Use of Respondeat Superior as Means of Imposing Secondary Liability Under Securities Exchange Act of 1934—Sharp v. Coopers & Lybrand*, 629 F.2d 175 (3d Cir. 1981), cert. denied 102 S. Ct. 427 (1982), 55 TEMP. L. Q. 238, 261 (1982) ("section 20(a) is the exclusive means to impose secondary liability for violations" of the 1934 Act); J. Christopher York, Comment, *Vicarious Liability of Controlling Persons: Respondeat Superior and the Securities Acts—A Reversible Consensus in the Circuits*, 42 EMORY L.J. 313, 356–58 (1993) (arguing that Supreme Court precedent mandates exclusion of *respondeat superior* as a source of liability). But see John J. Musewicz, *Vicarious Employer Liability and Section 10(b): In Defense of the Common Law*, 50 GEO. WASH. L. REV. 754, 811 (1982) ("[S]ection 20(a) should supplement rather than preempt common-law employer-liability principles."); Kenneth I. Levin, Comment, *The Controlling Persons Provisions: Conduits of Secondary Liability Under Federal Securities Law*, 19 VILL. L. REV. 621, 643 (1974) (control person provisions were meant to supplement common law agency theories of secondary liability); William J. Seiter, Note, *Rule 10b-5 and Vicarious Liability Based on Respondeat Superior*, 69 CAL. L. REV. 1513, 1537 (1981) ("[R]espondeat superior should be permitted to coexist with section 20(a) as a source of secondary liability for violations of section 10(b) and Rule 10b-5.").

<sup>8</sup> Except for the D.C. Circuit, which has decided no relevant cases, and the Eleventh Circuit, which also has not had a chance to pass on the issue (and therefore presumptively follows the pre-1981 precedent of the Fifth Circuit), only the Third and Fourth Circuits did

when it held in *Central Bank of Denver v. First Interstate Bank of Denver*<sup>9</sup> that no aiding and abetting cause of action exists under section 10(b) and Rule 10b-5. Although the *Central Bank* majority did not expressly address other forms of secondary liability such as *respondeat superior*, there are several indications that *Central Bank* presages their demise: (1) Justice Stevens's dissent in *Central Bank* concluded that the majority opinion's logic would lead to elimination not just of aiding and abetting, but of all forms of secondary liability, including *respondeat superior* and conspiracy;<sup>10</sup> (2) Professor Fischel's classic article on secondary liability,<sup>11</sup> which the *Central Bank* majority found sufficiently

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not fully embrace *respondeat superior* in the pre-*Central Bank* era. Thus, the following cases are representative of circuit court rulings that section 20(a) did not displace *respondeat superior* in section 10(b) and Rule 10b-5 litigation:

First Circuit: *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 32-35 (1st Cir. 1986).

Second Circuit: *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980).

Fifth Circuit: *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980).

Sixth Circuit: *Holloway v. Howerdd*, 536 F.2d 690, 695 (6th Cir. 1976).

Seventh Circuit: *Henricksen v. Henricksen*, 640 F.2d 880, 887 (7th Cir. 1981).

Eighth Circuit: *Commerford v. Olson*, 794 F.2d 1319, 1323 (8th Cir. 1986).

Ninth Circuit: *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577-78 (9th Cir. 1990) (en banc).

Tenth Circuit: *Kerbs v. Fall River Indus.*, 502 F.2d 731, 739-41 (10th Cir. 1974).

The Third Circuit has resisted the application of *respondeat superior*, but has created exceptions for situations in which the defendant had a "special duty" to supervise the wrongdoer. *See, e.g.*, *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 181 (3d Cir. 1981) (accounting firm defendant); *Roches Bros. v. Rhoades*, 527 F.2d 880, 884-86 (3d Cir. 1975) (broker-dealer defendant). Indeed, one commentator has suggested that the effect of the exceptions was to replace the Rule. *See* Patrick W. Foley, Note, *Vicarious Liability Respondeat Superior Applicable in Cases Involving High Fiduciary Duties Despite Controlling Persons Provision of Securities Exchange Act—Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), 12 SETON HALL L. REV. 353, 366-67 (1982).

The Fourth Circuit has also resisted application of *respondeat superior*. *See, e.g.*, *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979). The court, however, does not explicitly overrule those earlier cases that have embraced it. *See, e.g.*, *Carras v. Burns*, 516 F.2d 251, 260-61 (4th Cir. 1975); *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1130 (4th Cir. 1970).

<sup>9</sup> 511 U.S. 164 (1994).

<sup>10</sup> *See id.* at 200, 201 n.12 (Stevens, J., dissenting) (concluding that decisions recognizing conspiracy and *respondeat superior* under section 10(b) and Rule 10b-5 "appear unlikely to survive the Court's decision").

<sup>11</sup> *See* Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act*

persuasive as to the aiding and abetting issue to cite it several times,<sup>12</sup> called not only for the end of aiding and abetting liability under section 10(b) and Rule 10b-5, but also for the abolition of *respondeat superior* liability;<sup>13</sup> (3) virtually every post-*Central Bank* commentator addressing the issue has predicted the extinction of *respondeat superior* liability;<sup>14</sup> (4) almost every court to address

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of 1934, 69 CAL. L. REV. 80, 111 (1981) (arguing that the logic of Supreme Court precedent mandated elimination of theories of secondary liability not expressly provided for by Congress).

<sup>12</sup> See *Central Bank*, 511 U.S. at 169, 184, 191. Not only did the Court cite Fischel's article three times, it also seemingly drew its mode of analysis (examine statutory language, then statutory framework, then legislative history, then policy arguments) from Fischel's article. See *id.* at 169-91; Fischel, *supra* note 11, at 94-102.

<sup>13</sup> Fischel, *supra* note 11, at 88, 97-99, 107, 111.

<sup>14</sup> See, e.g., Alan R. Bromberg, *Aiding and Abetting: Sudden Death and Possible Resurrection*, 27 REV. SEC. & COMM. REG. 133, 137-38 (1994) (apparently agreeing with Justice Stevens's dissent that *respondeat superior* is no longer viable under the reasoning of *Central Bank*); Thomas O. Gorman, *Who's Afraid of 10b-5? The Scope of a Section 10(b) Cause of Action After Central Bank of Denver*, 22 SEC. REG. L.J. 247, 257 (1994) (*Central Bank* "must be read as a death knell for the application of all forms of common-law secondary liability in section 10(b) cases."); Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1435 (1994) ("[T]here also would appear to be no principled basis for not extending the logic of *Central Bank* to prohibit other implied . . . liability claims under section 10(b) such as those involving *respondeat superior*.") [hereinafter Seligman, *Central Bank*]; Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489, 497 n.55 (1995) ("The Court's decision should also preclude use of the common law theories of conspiracy and *respondeat superior*"); Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1786 n.13 (1994) (*Central Bank*'s holding "arguably impl[ies] the rejection of *respondeat superior* under the federal securities laws."); Lisa Klein Wager & John E. Failla, *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.—The Beginning of an End, or Will Less Lead to More?*, 49 BUS. LAW. 1451, 1462 (1994) ("[T]he viability of any precedent applying such common law principles [as *respondeat superior*] . . . certainly must be questioned, if not rejected out of hand, after the decision in *Central Bank*."); Sean G. Blackman, Note, *An Analysis of Aider and Abettor Liability Under Section 10(b) of the Securities Exchange Act of 1934: Central Bank of Denver v. First Interstate Bank of Denver*, 27 CONN. L. REV. 1323, 1372 (1995) ("[I]t is clear that . . . *respondeat superior* . . . will now be treated as suspect by the courts."); Nathan F. Coco, Comment, *Has Legislative History Become History?: A Critical Examination of Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 20 J. CORP. L. 555, 569 (1995) ("[I]t is unlikely that *respondeat superior* or conspiracy claims will survive *Central Bank*."); Carrie E. Goodwin, Note, *Central Bank v. First Interstate Bank: Not Just the End of Aiding and Abetting Under Section 10(b)*, 52 WASH. & LEE L. REV. 1387, 1425 (1995) (Post-*Central Bank* "actions based on common-law vicarious liability should no longer exist when the defendant is able to comply with section 20(a)'s good-faith defense."); Anthony J.

the issue of whether *Central Bank's* logic compels elimination of conspiracy, another secondary liability theory under section 10(b) and Rule 10b-5, has held that it does;<sup>15</sup> and (5) finally, although the lower courts are split, at least five courts have cited *Central Bank* in either specifically ruling or intimating that *respondeat superior* is no longer a viable means of imposing liability in section 10(b) and Rule 10b-5 cases.<sup>16</sup>

Thus, continued recognition of *respondeat superior* liability under section 10(b) and Rule 10b-5 is truly in peril. The inconceivable is being conceived,

Jorgenson, Comment, *Securities Law: Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.: The Supreme Court Abolishes Aiding and Abetting Liability Under Section 10(b): The End of an Era, or a Break in the Action?*, 47 OKLA. L. REV. 641, 672 (1994) (*respondeat superior* is "at risk" after *Central Bank*); John Kalmbach, Note, *Central Bank of Denver v. First Interstate Bank of Denver: Rethinking Established Section 10(b) Doctrines*, 55 LA. L. REV. 1009, 1019-20 (1995); John F. Olson et al., *The End of the Section 10(b) Aiding and Abetting Liability Fiction*, INSIGHTS, June 1994, at 3, 6 (*Central Bank's* "reasoning appears to spell the end to all forms of implied secondary liability under section 10(b), including . . . *respondeat superior*."). But see Nicole Miller, Note, *The Judicial Rejection of Aiding and Abetting Civil Liability Under Section 10(b): Will Central Bank of Denver Spell the End of the Implied 10(b) Cause of Action?*, 1995 UTAH L. REV. 913, 933-34 ("The future of *respondeat superior* under section 10(b)[ ] seems relatively secure.").

<sup>15</sup> See, e.g., *Securities Investor Protection Corp. v. Bell*, No. 94-56468, 1996 WL 26925, at \*1 (9th Cir. Jan. 23, 1996) (holding that *Central Bank* also renders conspiracy inactionable); *In re Glenfed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (same); *Phillips v. Kidder, Peabody & Co.*, 933 F. Supp. 303, 316 (S.D.N.Y. 1996) (same); *In re Faleck & Margolies, Ltd.*, Nos. 89 Civ. 8548 (SWK) and 90 Civ. 356 (SWK), 1995 WL 33631, at \*12 (S.D.N.Y. Jan. 30, 1995) (same); *Kidder Peabody & Co. v. Unigestion Int'l Ltd.*, 903 F. Supp. 479, 496 (S.D.N.Y. 1995) (same); *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 964 n.8 (D. Md. 1995) (same); *In re MTC Elec. Techs. Shareholders Litig.*, 898 F. Supp. 974, 981-82 (E.D.N.Y. 1995) (same); *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D.S.C. 1995) (same); *SEC v. United States Envtl., Inc.*, 897 F. Supp. 117, 119-20 (S.D.N.Y. 1995) (same); *Van De Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 738 (D. Mass. 1995) (same); *Upton v. McKerrow*, 887 F. Supp. 1573, 1580 (N.D. Ga. 1995) (same); *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994) (same). But see *In re Towers Fin. Corp. Noteholders Litig.*, 936 F. Supp. 126, 129-30 (S.D.N.Y. 1996) (distinguishing between conspiracy and aiding and abetting and refusing to hold that *Central Bank*, which did not directly address conspiracy claims, necessarily ended them). See generally Edward Brodsky, *The Conspiracy Question Revisited: The Scope of § 10(b)*, N.Y. L.J., Sept. 11, 1996, at 3 (arguing that *Towers* was wrongly decided).

<sup>16</sup> See *Tranchina v. Howard, Weil, La Bousse, Friedrichs, Inc.*, 1997 U.S. Dist. LEXIS 12361 at \*14 (E.D. La. Aug. 18, 1997); *In re Fidelity/Micron Sec. Litig.*, 1997 U.S. Dist. LEXIS 13616 at \*16 (D. Mass. Apr. 24, 1997); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, No. 94 Civ. 0119, 1996 WL 22979, at \*1 (S.D.N.Y. Jan. 23, 1996); *In re Prudential Ins. Co. of Am. Sales Practices Litig.*, 169 F.R.D. 598 (D.N.J. 1996); *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D.S.C. 1995).

and the preposterous is being implemented. If other lower courts also extirpate *respondeat superior* liability under section 10(b) and Rule 10b-5, making the predictions of Justice Stevens and the commentators come true, a momentous shift in settled law will occur and *Central Bank*'s impact will be much greater than it first appeared.<sup>17</sup>

Think of it! Without *respondeat superior* liability, it is arguable that no longer will accounting firms be proper Rule 10b-5 defendants (only individual accountants), no longer will law firms be appropriate Rule 10b-5 defendants (only individual lawyers), and no longer will corporations be sued for securities fraud (only their employees). The importance of such a potential development is difficult to overstate.<sup>18</sup> Such a sea of change in the law demands attention.<sup>19</sup>

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<sup>17</sup> The author has noted and largely agreed with many of the criticisms leveled at the majority opinion in *Central Bank*. For a summary of some of the more salient criticisms of the *Central Bank* holding, see Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 NO. CAR. L. REV. 691, 709-11 (1996).

The author has also somewhat optimistically predicted that *Central Bank* will have little impact if the lower courts properly construe the concept of primary liability under section 10(b) and Rule 10b-5. *Id.* at 716-80. Whether or not this is correct depends upon whether the author's belief that primary liability should be broadly conceived gains acceptance notwithstanding the fact that it is arguably inconsistent with the tone of the Supreme Court's majority opinion in *Central Bank*.

<sup>18</sup> Professor Seligman has indicated that the loss of *respondeat superior* liability would not be a major loss to securities law enforcement because controlling person liability under section 20(a) would still exist and because most *respondeat superior* cases have involved broker-dealers whose contracts with customers now almost universally call for arbitration rather than litigation. Seligman, *Central Bank*, *supra* note 14, at 1436.

Professor Seligman's first argument overlooks the fact that Congress enacted the controlling person provisions merely as a supplement to reach defendants that could not be reached under common law agency principles such as *respondeat superior*. See *infra* notes 389-410 and accompanying text. Many, perhaps most, section 10(b) and Rule 10b-5 defendants—corporations, law firms, accounting firms—have been reached through *respondeat superior*. Such firms do not in any realistic way "control" their wrongdoing agents; rather, it is the agents that "control" the principal. See *infra* notes 346, 429. Elimination of the *respondeat superior* theory of secondary liability could have tremendous repercussions.

Professor Seligman's second argument assumes that because the most vigorous litigation regarding the propriety of *respondeat superior* liability in light of the arguably exclusive nature of the controlling person provisions has occurred in broker-dealer cases, those are the only important cases. The fact is that it is only in broker-dealer cases that the issue has been heavily litigated. See *infra* note 44. In lawsuits against corporations, law firms, and accounting firms, it has been widely assumed, and rightly so, that *respondeat superior* liability applied. See *infra* note 42.

<sup>19</sup> This is especially true because *Central Bank*'s holding may cause many plaintiffs to

This Article makes a case for the continued recognition of *respondeat superior* liability under section 10(b) and Rule 10b-5. Part I provides basic background material, setting the stage for analysis. In particular, it discusses the Supreme Court's most recent approach to answering such questions, as explicated in *Central Bank*.

Part II follows the *Central Bank* mode of analysis to address the first key question underlying this Article: Other things being equal, whether *respondeat superior* liability should be recognized under section 10(b) and Rule 10b-5. In substantial part, the issue will be whether there are good and sufficient reasons to distinguish *respondeat superior* liability from aiding and abetting liability so that the former should not suffer the latter's unkind fate in the wake of *Central Bank*.

Part III addresses the second key question in this Article. It recognizes that other things are not equal given the existence of section 20(a) and seeks to answer the question of whether its controlling person provision should, in a post-*Central Bank* world, be construed to provide the sole means of imposing secondary liability under the 1934 Act.

## I. BACKGROUND

### A. Section 10(b) and Rule 10b-5 Generally

Section 10(b) makes it unlawful to commit manipulative or fraudulent acts in the purchase or sale of securities in violation of SEC-promulgated rules. Rule 10b-5 makes it illegal, among other things, "[t]o make any untrue statement . . . or to omit to state a material fact . . . or . . . [t]o engage in any . . . course of business which operates . . . as a fraud or deceit upon any person."<sup>20</sup> These are "sweeping words."<sup>21</sup> Given the litigation it has generated over the past thirty years or so,<sup>22</sup> section 10(b) and Rule 10b-5 are the most

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cast as *respondeat superior* claims those causes of action that they previously would have labeled as aiding and abetting. See Glen Shu, Comment, *Take a Second Look: Central Bank After the Private Securities Litigation Reform Act of 1995*, 33 HOUS. L. REV. 539, 570 (1996).

<sup>20</sup> 17 C.F.R. § 240.10b-5 (1997). For a discussion of the basic elements of a section 10(b) and Rule 10b-5 cause of action, see generally Robert A. Prentice & John H. Langmore, *Beware of Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies*, 8 HARV. J.L. & TECH. 1, 20-62 (1994).

<sup>21</sup> *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 303 (1993) (Thomas, J., dissenting).

<sup>22</sup> See Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 965 (1994) ("[T]he private right of action implied under Rule 10b-5 has become civil plaintiffs' primary weapon



significant securities antifraud provisions in the United States (or elsewhere).<sup>23</sup>

## B. Respondeat Superior

The general rule is and has long been that “a master is liable for the unauthorized torts of his servant if committed while the servant is acting within the scope of his employment.”<sup>24</sup> Also known as “vicarious liability,” *respondeat superior* liability<sup>25</sup> is strict in nature, requiring no fault on the part of the master.<sup>26</sup>

The term *respondeat superior* is often restricted to the employer-employee

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in their battle against securities fraud. Plaintiffs in class action securities fraud cases have claimed billions of dollars of damages for violations of the implied Rule 10b-5 private right.”) (footnote omitted).

<sup>23</sup> See Nat Stern, *The Constitutionalization of Rule 10b-5*, 27 RUTGERS L.J. 1, 1 (1995) (“Rule 10b-5 is probably the most familiar and most frequently invoked securities regulation.”) (footnote omitted); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463 (1989-1990) (observing that 10b-5 “has been given extraordinary prominence, almost eclipsing everything else as a source of federal securities law at least in the courts.”).

<sup>24</sup> HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, *HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP* 101 (1979).

<sup>25</sup> See RESTATEMENT (SECOND) OF AGENCY (1958). The Restatement breaks the subject of a master’s vicarious liability for the torts of its agents into two broad categories. First, section 219’s status-based *respondeat superior* provision states that “[a] master is subject to liability for the torts of his servants committed while acting in the scope of their employment.” *Id.* at § 219. Second, there are two provisions—section 257 (misrepresentations of others) and section 261 (fraud by agents)—that impose vicarious liability on an “apparent authority” basis. See *id.* at §§ 257, 261.

Section 257 states that “[a] principal is subject to liability for loss caused to another by the other’s reliance upon a tortious representation of a servant or other agent, if the representation is: (a) authorized; (b) apparently authorized; or (c) within the power of the agent to make for the principal.” *Id.* at § 257. Section 257(c) goes beyond both actual and apparent authority and is thus a fairly naked example of pure enterprise liability. See, e.g., *Celtic Life Ins. Co. v. Coats*, 885 S.W.2d 96, 98-99 (Tex. 1994).

Section 261 provides that “[a] principal who puts a servant or other agent in a position which enables the agent, while apparently acting within his authority, to commit a fraud upon third persons is subject to liability to such third persons for the fraud.” RESTATEMENT (SECOND) OF AGENCY § 261 (1958).

<sup>26</sup> See FOWLER V. HARPER & FLEMING JAMES JR., *THE LAW OF TORTS* 1367-68 (1956) (“[V]icarious liability . . . is imposed . . . in cases where the master has taken all the steps that reasonable foresight would suggest. . . . Indeed the court is not even interested in hearing whether the master exercised his right of control well and prudently.”); REUSCHLEIN & GREGORY, *supra* note 24, at 101.

relationship.<sup>27</sup> However, general agency principles often impose similar liability upon non-employer principals for the torts of their agents acting within the scope of authority.<sup>28</sup>

Usually the agent must be serving the master's ends for the master to be liable for the agent's torts. However, where a principal places the agent in a position to deceive third parties by apparently acting within the principal's authority, the principal is also liable to the third party on an agency basis, even if the agent was acting for the agent's own purposes.<sup>29</sup> The Supreme Court itself has noted that "a principal is liable for an agent's fraud though the agent acts solely to benefit himself, if the agent acts with apparent authority."<sup>30</sup>

This Article uses the term *respondeat superior* to cover all three of these well-established categories of agency liability.<sup>31</sup> A broader term like "agency liability" might be more precise, but the terms are often used interchangeably,<sup>32</sup> and the phrase *respondeat superior* seems to be more generally used by courts.<sup>33</sup>

Many rationales have been given for imposing strict *respondeat superior* liability, and these will be discussed at various places later in this Article.<sup>34</sup> The most important point to remember at this stage is that the rationales have been

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<sup>27</sup> See BALLENTINE'S LAW DICTIONARY 1106 (3d ed. 1969).

<sup>28</sup> Principals are usually not liable for the torts of independent contractors that they hire unless extrahazardous activities or nondelegable duties are involved. See *Voigts v. Brutoco Eng'g & Constr. Co.*, 57 Cal. Rptr. 2d 87, 89, 105 (Ct. App. 1996); *MBank El Paso v. Sanchez*, 836 S.W.2d 151, 153 (Tex. 1992).

<sup>29</sup> See RESTATEMENT (SECOND) OF AGENCY §§ 261, 262 (1958).

<sup>30</sup> *American Soc'y of Mechanical Eng'rs v. Hydrolevel Corp.*, 456 U.S. 556, 566 (1982).

<sup>31</sup> These rules of liability are not controversial. They are quite well established and ubiquitously applied in American jurisprudence. For a slightly more detailed summary of them, see York, *supra* note 7, at 324-28.

<sup>32</sup> See William H. Kuehnle, *Decision on Vicarious Liability Moves 9th Circuit to Mainstream*, NAT'L L.J., Feb. 18, 1991, at 33 ("Agency liability [is] often called respondeat superior liability . . . [and i]t makes one liable when one's employee commits a tort while working within his or her scope of employment (master-servant liability) or when one's agent commits a tort while acting with the apparent authority of the principal (apparent authority liability).").

<sup>33</sup> See York, *supra* note 7, at 324 ("Courts often fail to distinguish the nuances of agency theory, content to label most common law actions 'respondeat superior.'") (footnotes omitted).

<sup>34</sup> Because the principal may well be blameless in *respondeat superior* cases, significant policy reasons must be (and have been) located in order to impose liability. In apparent authority cases, liability is based on the notion that people should be held responsible for the results flowing from their objective manifestations of conduct, regardless of their subjective intentions. See RESTATEMENT (SECOND) OF AGENCY § 8 cmt. d (1958).

found so persuasive over the last couple of centuries that the doctrine of *respondeat superior* is simply universal in Western jurisprudence.<sup>35</sup> It is, in the words of Professor Langevoort, “a foundational element of tort law.”<sup>36</sup>

### C. Section 20(a) and “Controlling Persons”

Section 20(a) of the Securities Exchange Act of 1934, which is patterned upon a similar provision in section 15 of the Securities Act of 1933,<sup>37</sup> imposes vicarious joint and several liability for securities fraud on “controlling persons” for the conduct of those they control, unless the controlling persons act in good faith and do not induce the controlled person’s conduct.<sup>38</sup> Once the plaintiff establishes a *prima facie* case that defendants controlled the wrongdoers, the burden of proof shifts to the defendants to prove that they acted in good faith.<sup>39</sup> The good faith defense available to controlling person defendants creates an important distinction between this form of secondary liability on the one hand, and *respondeat superior* with its strict liability on the other.<sup>40</sup>

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<sup>35</sup> See generally Robert Neuner, *Respondeat Superior in the Light of Comparative Law*, 4 LA. L. REV. 1, 1 (1941) (comparing United States, English, French, German, Austrian, and Czech law); Schwartz, *supra* note 3, at 1745 (noting that vicarious employer liability is fully implemented in England, France, and Canada, but has some limitations in Germany and Japan); E. Fabre Surveyer, *A Comparison of Delictual Responsibility in Law in the Countries Governed by a Code*, 8 TUL. L. REV. 53, 63–66 (1933–1934) (discussing forms of agency liability in France, Italy, Egypt, Spain, Panama, and Canada).

<sup>36</sup> Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella’s History, Central Bank’s Future*, 20 DEL. J. CORP. L. 865, 894 (1995).

<sup>37</sup> 15 U.S.C. § 77o (1994) [hereinafter section 15]. It provides:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections [11] or [12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

*Id.*

<sup>38</sup> See 15 U.S.C. § 78t(a) (1994) [hereinafter section 20(a)].

<sup>39</sup> See SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1473 (2d Cir. 1996); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980); Gordon v. Burr, 506 F.2d 1080, 1086 (2d Cir. 1974).

<sup>40</sup> Courts interpret the good faith defenses of section 15 and section 20(a) to be functionally identical, see Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1578 (9th Cir.

### D. *The Controlling Persons or Respondeat Superior Debate*

*Respondeat superior* has been applied in section 10(b) cases as long as the implied cause of action has been recognized. Indeed, the seminal case implying the section 10(b) cause of action, *Kardon v. National Gypsum Co.*,<sup>41</sup> held a corporate defendant potentially liable. Many cases throughout the 1940s and 1950s similarly applied the doctrine of *respondeat superior* liability, seemingly without giving it a second thought.<sup>42</sup> However, in 1967, the Ninth Circuit, in *Kamen & Co. v. Paul H. Aschkar & Co.*,<sup>43</sup> began holding that the controlling person provision of section 20(a) provided the exclusive form of vicarious liability under the 1934 Act.<sup>44</sup> The basic reasoning of the line of cases that arose from *Kamen* was that recognition of *respondeat superior* with its imposition of liability upon even faultless principals is impermissibly inconsistent with the express provision of a good faith defense for controlling persons in section 20(a).

As noted earlier, many commentators agreed with the *Kamen* holding,<sup>45</sup>

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1990) (en banc) (a defendant has "the same good faith defense available to it under § 15 as it has under § 20(a)"). Section 15(a), however, seems to use an objective reasonable person standard while section 20(a) seems to impose a subjective standard geared to the particular defendant's state of mind. See Nancy C. Staudt, Note, "*Controlling*" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts, 72 MINN. L. REV. 930, 939 (1988) (contrasting the two provisions).

<sup>41</sup> 69 F. Supp. 512 (E.D. Pa. 1946).

<sup>42</sup> See, e.g., *Speed v. Transamerica Corp.*, 235 F.2d 369, 370, 373 (3d Cir. 1956) (corporate defendant); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951) (same); *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14, 24 (W.D. Ky. 1960) (same); *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954, 964 (N.D. Ill. 1952) (same); *Robinson v. Difford*, 92 F. Supp. 145, 149 (E.D. Pa. 1950) (same); *Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 123 (W.D. Ark. 1949) (partnership defendant). Even the cases exonerating corporate defendants for other reasons assumed the applicability of *respondeat superior*. See, e.g., *Smith v. Bear*, 237 F.2d 79, 88 (2d Cir. 1956) (partnership defendant); *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701, 705 (S.D.N.Y. 1951) (corporate defendant), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

The SEC has similarly applied *respondeat superior*. See, e.g., *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *In re H.F. Schroeder & Co.*, 27 S.E.C. 833, 837 (1948).

<sup>43</sup> 382 F.2d 689 (9th Cir. 1967).

<sup>44</sup> *Kamen's* holding was anything but clear. The court never explicitly concluded that the controlling person provision of section 20(a) is the exclusive means of imposing secondary liability under the 1934 Act. See *Kamen*, 382 F.2d at 694-97. What is important, however, is that later courts interpreted the *Kamen* opinion as so holding. See, e.g., *Zweig v. Hearst Corp.*, 521 F.2d 1129, 1132 (9th Cir. 1975).

<sup>45</sup> See *supra* note 7.

and it gained limited acceptance in the lower courts. However, twenty-four years after *Kamen* the Ninth Circuit finally threw in the towel<sup>46</sup> and joined the large majority of other circuits in rejecting the *Kamen* exclusivity rationale and recognizing *respondeat superior* as another viable means of imposing vicarious liability in section 10(b) and Rule 10b-5 cases.<sup>47</sup>

### E. Central Bank and Its Holding

In *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>48</sup> the Supreme Court did not directly address either *respondeat superior* or section 20(a). Nonetheless, its ruling on another form of secondary liability, aiding and abetting, necessarily had significant implications for both. Without repeating the copious summaries and commentaries on *Central Bank* already extant,<sup>49</sup> its

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<sup>46</sup> See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-78 (9th Cir. 1990) (en banc).

<sup>47</sup> See *supra* note 8.

<sup>48</sup> 511 U.S. 164 (1994).

<sup>49</sup> In addition to the articles and notes cited *supra* note 14, see, e.g., James D. Cox, *Just Desserts for Accountants and Attorneys After Bank of Denver*, 38 ARIZ. L. REV. 519, 519-45 (1996); Ann Maxey, *Competing Duties? Securities Lawyers' Liability After Central Bank*, 64 FORDHAM L. REV. 2185, 2204-27, 2237 (1996); James D. Redwood, *Toward a More Enlightened Securities Jurisprudence in the Supreme Court? Don't Bank on It Anytime Soon*, 32 HOUS. L. REV. 3, 4-65 (1995); David S. Ruder, *The Future of Aiding and Abetting and Rule 10b-5 After Central Bank of Denver*, 49 BUS. LAW. 1479, 1482-87 (1994); David J. Baum, Comment, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817, 1833-52 (1995); Stephen H. Brown, Note, *Central Bank: The End of Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 46 MERCER L. REV. 1515, 1515-26 (1995); Craig J. Concannon, Note, *Central Bank of Denver v. First Interstate Bank: The End of Aiding and Abetting Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 14 ST. LOUIS U. PUB. L. REV. 679, 681-700 (1995); Scott M. Murray, Comment, *Central Bank of Denver v. First Interstate Bank of Denver: The Supreme Court Chops a Bough from the Judicial Oak: There Is No Implied Private Remedy to Sue for Aiding and Abetting Under Section 10(b) and SEC Rule 10b-5*, 30 NEW ENG. L. REV. 475, 501-45 (1996); Jeffrey D. Snavelly, Note, *Central Bank v. First Interstate Bank: Will the Death of the Salesman Stop the Selling?*, 26 U. TOL. L. REV. 695, 707-24 (1995); Susan E. Springer, Note, *Central Bank v. First Interstate Bank and the Demise of Section 10(b) Private Aiding and Abetting Liability: Opting for a Rule of Economic Efficiency*, 4 GEO. MASON L. REV. 213, 227-50 (1995); JoErin O'Leary, Recent Decision, *Securities Regulation—Central Bank, Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 33 DUQ. L. REV. 1053, 1053-71 (1995); Edward Brodsky, *Aiding and Abetting Claims Under Rule 10b-5*, N.Y. L.J., June 14, 1995, at 3; Roberta S. Karmel, *Implications of the 'Central Bank of Denver' Case*, N.Y. L.J., June 16, 1994, at 3; John F.X. Peloso & Stuart M. Sarnoff, *What Now for Aider and Abettor Liability?*, N.Y. L.J.,

essential holding was that a private plaintiff may not maintain an aiding and abetting claim under section 10(b) or Rule 10b-5 because, most importantly, the statutory text does not explicitly provide for it.<sup>50</sup> That holding alone does not bode well for recognition of other forms of secondary liability that, like *respondeat superior*, are not mentioned in the text of the statute. Naturally, deeper analysis is needed and perhaps the most important product of *Central Bank* is the majority's current thinking regarding the proper approach to answering questions about the scope and meaning of section 10(b) and Rule 10b-5.

The process explicated by the Court seems to have the following steps. First, the issue presented must be categorized. The Court stated that its prior analysis had turned on whether the question presented regarded (1) the scope of conduct prohibited by section 10(b), or (2) given a violation of section 10(b), the elements of liability in the implied section 10(b) and Rule 10b-5 cause of action.<sup>51</sup>

Second, once the issue is categorized, the proper mode of analysis must be applied. The Court stated (inaccurately)<sup>52</sup> that when it previously had decided

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June 16, 1994, at 3.

<sup>50</sup> See *Central Bank*, 511 U.S. at 177. To be slightly more thorough, the Court held that not only does the text of the statute not mention secondary liability, but also the following: (a) no express liability provision in either the 1933 or the 1934 Acts includes an aiding and abetting cause of action, *id.* at 179; (b) legislative developments occurring after passage of the Act do not clearly indicate that Congress wished aiding and abetting liability to exist, *id.* at 185-88; (c) policy arguments do not demonstrate that elimination of aiding and abetting liability would lead to results "so bizarre" as to override the clarity of the text, *id.* at 188-90; and (d) imposition of aiding and abetting liability cannot be based on the general federal criminal aiding and abetting law (18 U.S.C. § 2), *id.* at 190-91.

<sup>51</sup> See *Central Bank*, 511 U.S. at 172.

<sup>52</sup> In point of fact, the Court had previously used broader means of statutory interpretation in determining questions regarding the scope of conduct prohibited by section 10(b). See Bromberg, *supra* note 14, at 136 n.28 and accompanying text. Indeed, Professor Fallone has accurately noted:

Perhaps the most damning criticism of the Supreme Court's majority opinion in [*Central Bank*] is that it attempts to recharacterize earlier precedent in order to conform it with a newly announced—and very different—method of interpreting Section 10(b). At most, the Supreme Court's decision represents an unjust attempt to redefine legal rights available to defrauded investors in light of current judicial attitudes. At the very least, judicial candor requires that the majority recognize a major shift in its method of statutory analysis involving securities fraud.

Edward A. Fallone, *Section 10(B) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV.

issues regarding the scope of conduct, the text of the statute had controlled its analysis.<sup>53</sup> However, when it had decided questions regarding the elements of liability, the Court had been required to infer how the 1934 Congress would have addressed the issue had an express cause of action been included in the 1934 Act.<sup>54</sup>

Third, even if the text does control the analysis and does give a clear answer to the scope of conduct question presented, the Court may bolster its conclusion by attempting to infer how the 1934 Congress would have addressed the issue had there been an express cause of action.<sup>55</sup> Functionally, this allows a court handling an elements of liability issue to engage in the same analysis it would have used had it been handling a scope of conduct issue, after skipping analysis of the wording of the statute. Using the 1934 Act's express causes of action as a model are the preferred means of inferring the intent of the 1934 Congress in this regard.<sup>56</sup>

Fourth, the Court may examine legislative history and other evidence of congressional intent. Although such evidence is technically irrelevant to analysis supposedly controlled by the text of the statute, the Court virtually always considers it in interpreting federal statutes,<sup>57</sup> especially securities statutes,<sup>58</sup> and did so in *Central Bank*.<sup>59</sup> In relation to determining congressional intent, *Central Bank* announced, congressional reenactment of statutes previously given certain interpretations by the courts and congressional failure to enact laws are not especially helpful indicators.<sup>60</sup>

Fifth, again despite arguable irrelevance to the task of inferring

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71, 95.

<sup>53</sup> See *Central Bank*, 511 U.S. at 173.

<sup>54</sup> See *id.* at 178 (citing *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993)).

<sup>55</sup> See *Central Bank*, 511 U.S. at 178.

<sup>56</sup> See *id.*

<sup>57</sup> See Patricia M. Wald, *Some Observations on the Use of Legislative History in the 1981 Supreme Court Term*, 68 IOWA L. REV. 195, 195 (1982-1983) ("No occasion for statutory construction now exists when the court will not look at legislative history."); Stephanie Wald, *The Use of Legislative History in Statutory Interpretation—Cases in the 1992 U.S. Supreme Court Term; Scalia Rails but Legislative History Remains on Track*, 23 SW. U. L. REV. 47, 49 (1993) (case-by-case illustration).

<sup>58</sup> See Randall W. Quinn, *The Supreme Court's Use of Legislative History in Interpreting the Federal Securities Laws*, 22 SEC. REG. L.J. 262, 265 (1994) (finding, as of the end of 1992-1993 term, fifty-three Supreme Court cases referring to legislative history in interpreting federal securities statutes).

<sup>59</sup> See *Central Bank*, 511 U.S. at 183-85.

<sup>60</sup> See *id.* at 185-87. The Court admitted that its previous holdings in this area were quite inconsistent. *Id.* at 187.

congressional intent, a court may examine policy arguments. In *Central Bank*,<sup>61</sup> as in other securities cases,<sup>62</sup> the Court displayed its predilections regarding policy issues.<sup>63</sup>

## F. Lower Court Responses

Surprisingly, as of this writing few cases since *Central Bank* have directly ruled on its implications for the continued viability of *respondeat superior* under section 10(b) and Rule 10b-5. Those that have ruled have split on the issue.

### 1. Cases Eliminating Respondeat Superior Liability

Judge Carter of the Southern District of New York became the first judge to begin to make Justice Stevens's prognostication about the demise of *respondeat superior* come true when he ruled in *ESI Montgomery County, Inc. v. Montenay International Corp.*<sup>64</sup> The case involved the purchase by ESI of a limited partnership interest constituting a 72% interest in a limited partnership that owned and operated a waste-to-energy facility. Defendants included the following: (a) Montenay Energy Resources of Montgomery County, Inc. ("MERMCI"), general partner of the limited partnership, (b) Montenay International Corporation ("MIC"), 100% owner of MERMCI and 28% owner (through related entities) of the limited partnership, and (c) Montenay Montgomery Trust ("MMT"), a common law trust created for the benefit of MIC and its affiliated companies, which was a limited partner until ESI's purchase. After the purchase, ESI claimed in a section 10(b) and Rule 10b-5 action that it had been defrauded in the negotiations by false statements regarding the limited partnership's financial status, liabilities, and tax basis.

MERMCI moved for dismissal on grounds that it did not make material

<sup>61</sup> *Id.* at 188-90 (stressing disadvantages of securities litigation).

<sup>62</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737-55 (1975) (Justice Rehnquist's majority opinion displaying an overtly hostile attitude toward securities fraud litigation).

<sup>63</sup> The following chart seems to capture the Supreme Court's current thinking regarding the order of analysis after the type of issue presented is determined:

	Scope of Conduct	Elements of Liability
Statutory Text	1	
Inference From Other Statutes	2	1
Legislative History	3	2
Policy Considerations	4	3

<sup>64</sup> No. 94 Civ. 0119 (RLC), 1996 WL 22979, at \*1 (S.D.N.Y. Jan. 23, 1996).



misrepresentations and omissions to ESI, noting that it was not a party to the contract. ESI argued the MERMCI should nonetheless be held liable, alleging "that three officers of MERMCI led the negotiations for sale of the partnership interest to ESI and repeated orally and in writing to ESI the misrepresentations."<sup>65</sup> However, Judge Carter held that these allegations did not implicate MERMCI as a corporation because *Central Bank's* reasoning eliminated all forms of secondary liability, including those based on *respondeat superior*.<sup>66</sup>

The second case holding that *Central Bank* eliminated *respondeat superior* liability was *In re Prudential Insurance Co. of America Sales Practices Litigation*.<sup>67</sup> The suit was brought against Prudential by policyholders who alleged that they were induced by various false representations to purchase variable appreciable life insurance policies. Although common law fraud and other claims survived, the trial judge dismissed the section 10(b) and Rule 10b-

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<sup>65</sup> See *id.* at \*1, 2.

<sup>66</sup> See *id.* at \*3. Judge Carter nonetheless refused to dismiss MERMCI from the suit, holding it potentially liable on a second theory. The reasoning is somewhat peculiar and contradictory. Rule 9(b) of the Federal Rules of Civil Procedure requires, of course, that all averments of fraud be stated with particularity. See FED. R. CIV. P. 9(b). Under the "group pleading" rule, see *Luce v. Edelstein*, 802 F.2d 49, 54 (2d Cir. 1986), a plaintiff's allegations of fraud pass muster for specificity even without showing a specific connection between a particular defendant and the false representations so long as the defendant is an insider or affiliate participating in the transaction. *Id.* at 55. The "group pleading" rule is intended to aid plaintiffs in stating claims against officers and directors of companies who are actively involved in running those companies on the assumption that discovery will likely turn up evidence that such active parties were involved in the false statements. See *ESI*, 1996 WL 22979, at \*3. Judge Carter believed that there are two requirements for application of the "group pleading" doctrine: (a) that defendant is an insider or affiliate participating in the transaction, and (b) "that the complaint alleges particular facts demonstrating the knowledge of defendants at the time the statements were false." *Id.* at \*4. The second requirement stems from the Second Circuit's ruling in *DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1248 (2d Cir. 1987). See *ESI*, 1996 WL 22979, at \*4.

Judge Carter held that the first requirement was met because MERMCI was an indirect subsidiary and therefore an "affiliate" of MIC. Judge Carter held that the second element of the "group pleading" doctrine was also met because Sandner, an officer of MERMCI and MIC, had made a misrepresentations to ESI, demonstrating "that the defendants knew that their statements were false at the time the statements were made." See *id.* at \*4-5.

Thus, Judge Carter held that the knowledge of an officer of MERMCI could be imputed to MERMCI for purposes of satisfying the "group pleading" rule of section 10(b) and Rule 10b-5, but that that same officer's misrepresentations could not be imputed to MERMCI for *respondeat superior* purposes. See *id.* at \*5. The judge did not explain the obvious inconsistency. In either event, MERMCI could "act" and "know" only through its officers.

<sup>67</sup> No. 1061, CIV. A. 95-4704, 1996 WL 908944 (D.N.J., June 7, 1997).

5 claim on grounds that *Central Bank* had eliminated *respondeat superior* liability and therefore Prudential could not be liable for its agents' actions.

In April of 1997, Judge Stearns in Massachusetts also held, in an interesting case involving the alleged manipulation of Micron Technologies stock by principals of the Fidelity Magellan Fund, that *Central Bank* had eliminated *respondeat superior* liability.<sup>68</sup>

## 2. Cases Continuing to Recognize Respondeat Superior Liability

At least two courts have refused to hold that *Central Bank* eliminated *respondeat superior* liability under section 10(b) and Rule 10b-5.<sup>69</sup> In *Pollack v. Laidlaw Holdings, Inc.*,<sup>70</sup> the court essentially held that agency liability is more strongly established under traditional federal law than aiding and abetting liability and therefore should not be lightly eliminated.<sup>71</sup> And in *Seolas v. Bilzerian*,<sup>72</sup> Judge Winder in Utah followed *Pollack* for several well-articulated reasons.<sup>73</sup> The remainder of this Article will demonstrate that these courts have it right.<sup>74</sup>

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<sup>68</sup> *In re Fidelity/Micron Sec. Litig.*, 1997 U.S. Dist. LEXIS 13616, at \*16 (D. Mass. Apr. 24, 1997). A fourth court has indicated in dicta that it agreed that *Central Bank* spelled the end of *respondeat superior* liability. *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D.S.C. 1995). And a fifth court has indicated that although it "agree[d] philosophically" with the defendant's argument that *Central Bank*'s reasoning foreclosed *respondeat superior* liability in Rule 10b-5 cases, it felt bound by pre-*Central Bank* Fifth Circuit precedent to the contrary. *See Tranchina v. Howard, Weil, La Buisse, Friedrichs, Inc.*, 1997 U.S. Dist. LEXIS 12361 at \*14 (E.D. La. Aug. 18, 1997).

<sup>69</sup> In *AT&T Co. v. Winback & Conserve Program, Inc.*, 42 F.3d 1421, 1429-32 (3d Cir. 1994), the court in a Lanham Act case discussed the impact of *Central Bank*'s reasoning in contexts outside securities law and concluded that it did not mandate the extinction of *respondeat superior* in those other contexts.

<sup>70</sup> No. 90 Civ. 5788 (DLC), 1995 WL 261518, at \*1 (S.D.N.Y. May 3, 1995).

<sup>71</sup> *See id.* at \*17. By so holding the court bolstered Langevoort's argument that a Supreme Court attempt to revolutionize the law in *Central Bank* may well be stymied by lower court resistance. *See Langevoort, supra* note 36, at 867 (predicting that lower court inertia will prevent the pendulum from swinging as far as the tone of the majority opinion might indicate).

<sup>72</sup> 951 F. Supp. 978 (D. Utah 1997).

<sup>73</sup> *See id.* at 981-84.

<sup>74</sup> *See Riggs v. Schappell*, 939 F. Supp. 321, 325-29 (D.N.J. 1996). In *Riggs*, the court seemed to assume that pre-*Central Bank* Third Circuit law was still viable. As noted earlier, the Third Circuit had been one of the few jurisdictions hostile to *respondeat superior* liability, and even it had created some exceptions. Still, the *Riggs* opinion was very suspicious of the *respondeat superior* and other agency theories, but apparently held ultimately that even if they did apply, their elements were not present in this case.

## II. *CENTRAL BANK AND RESPONDEAT SUPERIOR*

This section deals with the first of two intertwined issues that were raised in the introduction: *Ceteris paribus*, should *respondeat superior* be recognized under section 10(b) and Rule 10b-5? That is, are there good and sufficient reasons to distinguish *respondeat superior* liability from aiding and abetting liability so that the former need not be undone by *Central Bank*'s reasoning? The resolution of this issue is inextricably interwoven with the question of whether section 20(a)'s controlling person provision should be construed to provide the exclusive means of imposing secondary liability under the 1934 Act. Nonetheless, most of the direct discussion of that issue is reserved for Part III.

### A. *Categorize the Issue*

*Central Bank* first requires a determination of whether a scope of conduct issue or an elements of liability issue is presented.

#### 1. *Scope of Conduct Issue*

##### a. *General Discussion*

As shall soon be explained, the availability of *respondeat superior* liability presents, in the Supreme Court's taxonomy, an elements of liability issue rather than a scope of conduct issue. However, Fischel has seemingly assumed that the *respondeat superior* doctrine relates to scope of conduct and, based on that assumption, has argued in favor of its abolition that scienter is a requisite element of section 10(b) and Rule 10b-5 liability<sup>75</sup> based on the Supreme Court's holding in *Ernst & Ernst v. Hochfelder*.<sup>76</sup> From that holding, Fischel argued that *respondeat superior* liability, along with other forms of secondary liability, must disappear.<sup>77</sup> This argument must be taken particularly seriously, because, as noted earlier, the *Central Bank* opinion cited Fischel's article three separate times.<sup>78</sup>

Nonetheless, there are several reasons to reject Fischel's argument. First, as noted above and as will be explained in the next section, different questions are being addressed. That is, to the extent that the somewhat artificial

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<sup>75</sup> See *id.* at 193.

<sup>76</sup> 425 U.S. 185 (1976).

<sup>77</sup> Fischel, *supra* note 11, at 102-11.

<sup>78</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 169, 184, 191 (1994); see also *supra* note 12.

distinction between these two categories of issues is maintained, scienter is actually a scope of conduct issue while *respondeat superior* presents an elements of liability issue.<sup>79</sup>

Second, the defendant in *Hochfelder*, as in other Supreme Court cases involving section 10(b) and Rule 10b-5, including *Central Bank*, was a firm. Never did the Supreme Court point out that the firm itself did not and could not act with scienter. The Court's opinion simply assumed that the defendant accounting firm was liable for any violations by its employees and the key question was whether the employees acted with scienter or merely with negligence. Properly read, *Hochfelder* simply holds that accounting firms will not be liable for the mere negligence of their employees. In no way, shape, or form does it hint that accounting firms may escape *respondeat superior* liability for the intentional fraud of their agents. Indeed, it unmistakably assumes to the contrary.

Third, Fischel himself, in arguing that courts should impose secondary liability upon firms only when they are controlling persons under section 20(a), posed a hypothetical situation in which a corporate employee directs a fraud with the knowledge of the board of directors. Fischel approved of imposing secondary liability on the corporation after imputing the knowledge of the board to the firm, thus satisfying the scienter requirement.<sup>80</sup> How does one impute the knowledge of the board to the firm? There's only one way—*respondeat superior* or comparable agency principles. Thus, even Fischel concedes a role for *respondeat superior* in the enforcement of section 10(b) and Rule 10b-5.

A basic element of common law negligence is lack of due care,<sup>81</sup> yet careful principals are routinely held liable for their agents' carelessness.<sup>82</sup> A basic element of common law fraud is scienter,<sup>83</sup> yet blameless principals are

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<sup>79</sup> *Hochfelder* holds that a requisite element of a primary violation of section 10(b) and Rule 10b-5 is scienter. So do the rules of common law fraud. Then, under each situation, the next question should be: Once it is established that a primary violation has occurred, who is liable for it? Application of the *respondeat superior* doctrine begins with the assumption that a primary violation has been established and addresses the different issue of responsibility for that violation. See *Xaphes v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 600 F. Supp. 692, 696 (D. Me. 1985) (holding that principal is liable only if the agent's primary liability is established and the conditions of *respondeat superior* are met).

<sup>80</sup> Fischel, *supra* note 11, at 107 n.145.

<sup>81</sup> See, e.g., *Redland Soccer Club, Inc. v. Department of the Army*, 55 F.3d 827, 851 (3d Cir. 1995) (applying Pennsylvania law, breach of the duty of due care is an essential element of a negligence cause of action).

<sup>82</sup> See, e.g., *Li v. Yellow Cab Co.*, 532 P.2d 1226, 1229-30 (Cal. 1975) (famous comparative negligence case); *Kumkumian v. City of New York*, 111 N.E.2d 865, 869 (N.Y. 1953) (noted last clear chance doctrine case).

<sup>83</sup> See, e.g., *First Interstate Bank of Billings v. United States*, 61 F.3d 876, 880 (Fed.

routinely held liable for their agents' common law fraud.<sup>84</sup> Anyone contending that Congress meant anything different when it wrote section 10(b) must carry a heavy burden to provide clear and specific evidence to support that claim. Fischel has not done so.

## b. General Building Contractors

The Supreme Court itself rejected Fischel's argument in another context. In *General Building Contractors Association v. Pennsylvania*,<sup>85</sup> the Court held that section 1981 of the Civil Rights Act,<sup>86</sup> like section 10(b), could be violated only by intentional acts "by purposeful discrimination."<sup>87</sup> The Court was distinguishing section 1981 from Title VII of the Civil Rights Act of 1964,<sup>88</sup> which recognizes disparate impact cases in addition to intentional discrimination cases.<sup>89</sup> In holding that section 1981, like the Equal Protection Clause, can be violated only by intentional discrimination,<sup>90</sup> the Court nonetheless clearly implied that innocent defendants should be held liable on a *respondeat superior* basis for the intentional violations of section 1981 committed by their agents.<sup>91</sup> Although section 1981 contains no express provision for *respondeat superior*, since *General Building Contractors* the lower courts have, sensibly, imposed section 1981 liability upon innocent principals through the *respondeat superior*

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Cir. 1995) (intent to deceive is an element of the tort of fraud); *Kansa Reinsurance Co. v. Congressional Mtg. Corp.*, 20 F.3d 1362, 1375 (5th Cir. 1994) (same).

<sup>84</sup> See, e.g., *Washington Nat'l Ins. Co. v. Strickland*, 491 So. 2d 872, 874 (Ala. 1985) (blameless principal is liable for agent's fraud within the scope of authority); *Larsen Chelsey Realty Co. v. Larsen*, 656 A.2d 1009, 1021 (Conn. 1995) (same); *McCarthy v. Brockton Nat'l Bank*, 50 N.E.2d 196, 201 (Mass. 1943) (same).

<sup>85</sup> 458 U.S. 375 (1982).

<sup>86</sup> 42 U.S.C. § 1981 (1994).

<sup>87</sup> *General Bldg. Contractors*, 458 U.S. at 389-91.

<sup>88</sup> 42 U.S.C. § 2000e (1994).

<sup>89</sup> See, e.g., *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971) (striking down unjustified educational requirement carrying disparate racial impact).

<sup>90</sup> See *Personnel Administrator of Mass. v. Feeney*, 442 U.S. 256, 272 (1979) (neutral law with disproportionate impact does not violate Equal Protection Clause unless it is traced to a discriminatory purpose); *Arlington Heights v. Metropolitan Housing Dev. Corp.*, 429 U.S. 252, 264-65 (1977) (mere racially disproportionate impact is insufficient for equal protection violation).

<sup>91</sup> See *Flanagan v. A.E. Henry Com. Health Servs. Ctr.*, 876 F.2d 1231, 1235 (5th Cir. 1989) (*General Building Contractors* "clearly implied that agency principles will apply if liability is to be imposed against a defendant under section 1981 for the acts of another."). However, under the facts of *General Building Contractors*, no agency relationship existed between the defendants and the wrongdoers so vicarious liability was not warranted. *General Bldg. Contractors*, 458 U.S. at 392-95.

doctrine notwithstanding the lack of bad intent by the defendants.<sup>92</sup>

### c. Meritor

A similar situation occurs under Title VII of the Civil Rights Act of 1964. Section 706(g) provides that statutory employers must "intentionally" commit an "unlawful employment practice" in order to be liable for employment discrimination.<sup>93</sup> Fischel's argument could be lodged here as well; indeed, it has been noted that because "employers, in the traditional sense of that term, are most often corporations that act only through employee agents [and b]ecause a corporation itself cannot commit an unlawful practice, on one reading of the section, there can be no corporate liability."<sup>94</sup> Yet the courts have routinely imposed such liability,<sup>95</sup> and the Supreme Court, in *Meritor*

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<sup>92</sup> See, e.g., *Fitzgerald v. Mountain States Tel. & Tel. Co.*, 8 F.3d 1257, 1263 (10th Cir. 1995) (applying *respondeat superior* upon private employer for acts of supervisor); *Vance v. Southern Bell Tel. & Tel. Co.*, 863 F.2d 1503, 1512 (11th Cir. 1989) (corporate employer held liable); *Springer v. Seaman*, 821 F.2d 871, 881 (1st Cir. 1987) (holding *respondeat superior* doctrine available against government employer); *Hunter v. Allis-Chalmers Corp.*, 797 F.2d 1417, 1422 (7th Cir. 1986) (deliberate acts of supervisors imputed to employer); *Mitchell v. Keith*, 752 F.2d 385, 388-89 (9th Cir. 1985) (applying *respondeat superior* in 1981 suit); *EEOC v. Gaddis*, 733 F.2d 1373, 1380 (10th Cir. 1984) (same); *Miller v. Bank of Am.*, 600 F.2d 211, 213 (9th Cir. 1979) (*respondeat superior* applies to private employers); *Lewis-Kearns v. Mayflower Transit, Inc.*, 932 F. Supp. 1061, 1069 (N.D. Ill. 1996) (same); *Yates v. Hagerstown Lodge No. 212*, 878 F. Supp. 788, 798 (D. Md. 1995) (same); *Malone v. Schenk*, 638 F. Supp. 423, 425 (C.D. Ill. 1985) (same); *United Bhd. of Carpenters, Local Union 1519 v. Backman Sheet Metal Works, Inc.*, 598 F. Supp. 212, 220 (S.D. Ohio 1984) (same).

The lower courts have also imposed vicarious liability under related statutes, such as section 1982, see 42 U.S.C. § 1982 (1994) and the Fair Housing Act of 1968, see 42 U.S.C. § 3604 (1994), reasoning that between innocent parties the victim of the discrimination should prevail over the principal of the wrongdoing agent. See, e.g., *Chicago v. Matchmaker Real Estate Sales Ctr., Inc.*, 982 F.2d 1086, 1096-97 (7th Cir. 1992) (section 1982 and Fair Housing Act); *United States v. Incorporated Village of Island Park*, 888 F. Supp. 419, 444 (E.D.N.Y. 1995) (Fair Housing Act); *Beliveau v. Caras*, 873 F. Supp. 1393, 1401 n.5 (C.D. Cal. 1995) (Fair Housing Act).

<sup>93</sup> See 42 U.S.C. § 2000e-5(g)(1) (1994) (providing that a respondent who "has intentionally engaged in . . . an unlawful employment practice" may be subject to remedies under the act).

<sup>94</sup> J. Hoult Verkerke, *Notice Liability in Employment Discrimination Law*, 81 VA. L. REV. 273, 287 (1995).

<sup>95</sup> See, e.g., *Gary v. Long*, 59 F.3d 1391, 1395 (D.C. Cir. 1995) (in determining employer responsibility, court would apply Restatement (Second) on Agency provisions), *cert. denied*, 116 S. Ct. 569 (1995); *North v. Madison Area Ass'n for Retarded Citizens-*

*Savings Bank v. Vinson*,<sup>96</sup> instructed the lower courts to use *respondeat superior* and other agency principles to flesh out the liability rules for Title VII.<sup>97</sup> It did so notwithstanding the fact that the language of Title VII does not refer to vicarious liability and that the legislative history provides only vague support for its application.<sup>98</sup>

d. Monell

As weak as Fischel's scienter argument is, there is indirect precedent for it in a completely unrelated area. In *Monell v. Department of Social Services*,<sup>99</sup> the Supreme Court held for the first time that municipalities could be liable under section 1983 of the Civil Rights Act of 1871.<sup>100</sup> Simultaneously, the Court held that such municipalities could not be liable on a *respondeat superior* basis. Instead, they could be liable only when the municipality "under color of some official policy, 'causes' an employee to violate another's constitutional rights."<sup>101</sup> The Court stated:

[T]hat language cannot be easily read to impose liability vicariously on governing bodies solely on the basis of the existence of an employer-employee relationship with a tortfeasor. Indeed, the fact that Congress did specifically provide that A's tort became B's liability if B "caused" A to subject another to

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Developmental Ctrs. Corp., 844 F.2d 401, 407 (7th Cir. 1988) (employer may be held vicariously liable for supervisor's acts if discrimination of those acts are within the apparent scope of authority); *Flowers v. Crouch-Walker Corp.*, 552 F.2d 1277, 1282 (7th Cir. 1977) (employer held liable for any discrimination by employee supervisor); *Faragher v. City of Boca Raton*, 864 F. Supp. 1552, 1563 (S.D. Fla. 1994) (plaintiff may prove *respondeat superior* either directly or indirectly).

Some cases hold that there are two types of vicarious liability under Title VII: (1) strict liability for conduct of supervisory employees acting within the scope of their actual or apparent authority; and (2) negligence liability for acts of employees who are merely co-workers. See, e.g., *Hinton v. Methodist Hosp., Inc.*, 779 F. Supp. 956, 962 (N.D. Ind. 1991). This is consistent with *respondeat superior* principles because the co-workers who sexually harass their peers are clearly not acting within the scope of either actual or apparent authority.

<sup>96</sup> 477 U.S. 57 (1986).

<sup>97</sup> *Id.* at 72 ("Congress wanted courts to look to agency principles for guidance in this area.").

<sup>98</sup> See Michael J. Phillips, *Employer Sexual Harassment Liability Under Agency Principles: A Second Look at Meritor Savings Bank*, *FSB v. Vinson*, 44 VAND. L. REV. 1229, 1258-62 (1991).

<sup>99</sup> 436 U.S. 658 (1978).

<sup>100</sup> 42 U.S.C. § 1983 (1994).

<sup>101</sup> *Monell*, 436 U.S. at 692.

a tort suggests that Congress did not intend Sec. 1983 liability to attach where such causation was absent.<sup>102</sup>

Parallels between Fischel's scienter argument and *Monell*'s causation argument are apparent. However, *Monell* is easily distinguishable. First, the Supreme Court stressed the language of section 1983, which is, naturally, quite different than the language of section 10(b).<sup>103</sup> Section 1983 expressly requires that the person being held liable act under the color of some official policy. Most tortfeasors employed by municipalities do not so act. If they do act under official policy, then the municipality is held liable under the "final authority" doctrine that evolved after *Monell*. Under this doctrine, a form of liability that seems to parallel *respondeat superior* is imposed upon municipalities whenever the acts of their tortfeasor employees result from a decision made by a municipal official with final authority to make such decisions.<sup>104</sup> Thus, when a police officer commits an illegal search, the municipality is liable on an agency basis if the police officer is following the orders of a municipal official with "final authority" to authorize such searches and seizures or if the officer is acting consistently with customary police practices, even if unauthorized, in that municipality.<sup>105</sup>

Second, the Supreme Court found in the legislative history of section 1983 clear evidence that Congress rejected elements of vicarious liability by rejecting a draft that expressly contained such elements and replacing it with another.<sup>106</sup> There is no such evidence in the legislative history of section 10(b).<sup>107</sup>

Third, and of surpassing importance, the *Monell* majority believed that there were constitutional problems involved in imposing liabilities upon bodies

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<sup>102</sup> *Id.*

<sup>103</sup> Section 1983 reads as follows:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

42 U.S.C. § 1983 (1994).

<sup>104</sup> See *City of St. Louis v. Prapotnik*, 485 U.S. 112, 122-23 (1988) (plurality opinion).

<sup>105</sup> See Steven E. Comer, Note, *Municipal Liability Under Section 1983: The Rationale Underlying the Final Authority Doctrine*, 44 VAND. L. REV. 341, 344 (1991).

<sup>106</sup> See *Monell*, 436 U.S. at 692 n.57.

<sup>107</sup> No draft of the 1934 Act addressed *respondeat superior* liability one way or the other. Its availability was, it appears, simply assumed. See *infra* notes 208-26.



of state government that have an obligation to keep the peace.<sup>108</sup> Those constitutional considerations are irrelevant to section 10(b).

Finally, it should be stressed that although the Supreme Court, probably erroneously,<sup>109</sup> purported to eliminate *respondeat superior* under section 1983 on the basis of considerations of constitutionality, statutory language, and legislative history not relevant to section 10(b) and Rule 10b-5, the Court could not bring itself to undermine completely this form of vicarious liability that is so basic to Western tort law. Therefore, while pretending to eliminate *respondeat superior*, the Supreme Court clearly retained it in a limited form with its “final authority” rule. A municipality does not issue orders carrying “final authority”; its agents do.<sup>110</sup> So, the “final authority” rule turns out to be not a substitute for *respondeat superior* liability, but simply an artificially constructed limitation upon it comparable to the common law’s “scope of authority” requirement. A municipality remains liable on a *respondeat superior* basis for the acts of certain agents, but not for the acts of others. The artificial nature of the distinction has created extreme confusion in the lower courts and caused the doctrine to be heavily criticized.<sup>111</sup>

In summary, Fischel’s argument based on the scienter requirement has already been rejected by the Supreme Court in many other settings and should not carry any persuasive power relating to section 10(b) and Rule 10b-5.

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<sup>108</sup> See *Monell*, 436 U.S. at 693.

<sup>109</sup> Kramer and Sykes, among others, have lodged persuasive arguments that the Supreme Court’s two primary rationales in *Monell*, both that based on the language of section 1983 and that based on the legislative history, were fatally flawed. See Larry Kramer & Alan O. Sykes, *Municipal Liability Under Section 1983: A Legal and Economic Analysis*, 1987 SUP. CT. REV. 249, 255–61; see also Karen M. Blum, *From Monroe to Monell: Defining the Scope of Municipal Liability in Federal Courts*, 51 TEMP. L. Q. 409, 413 n.15 (1978) (arguing that section 1983’s legislative history clearly indicates that Congress intended to impose vicarious liability); Randall R. Steichen, Comment, *Municipal Liability Under Section 1983 for Civil Rights Violations After Monell*, 64 IOWA L. REV. 1032, 1052 (1979) (“[L]anguage in section 1983 also indicates that Congress intended to hold municipalities liable for the actions of their employees on a theory closely related, if not identical, to the doctrine of *respondeat superior*.”).

<sup>110</sup> See Kramer & Sykes, *supra* note 109, at 253:

The problem [with the “final authority” rule] is that municipal action is always—can only be—carried out by persons employed by the municipality. Municipal liability is necessarily vicarious, and there is no such thing as “policy” that can make a municipality directly rather than vicariously responsible for a constitutional tort. “Policy” is merely a conclusion about which activities by which municipal employees should be vicariously attributed to the municipality for purposes of Sec. 1983.

<sup>111</sup> See *infra* note 433.

## 2. *Elements of Liability Issue*

Contrary to Fischel's assumption, the availability of *respondeat superior* liability really presents an elements of liability issue. Aiding and abetting is a cause of action that requires a definition of its scope; *respondeat superior* is a tort doctrine that allocates loss based on policy considerations.<sup>112</sup> In making a decision whether or not to apply vicarious liability, a court does not attempt to define the conduct that violates section 10(b) and Rule 10b-5. Rather, given that a violation of Rule 10b-5 (and, therefore, necessarily of section 10(b) as well) has occurred, the courts try to answer the question: Where should the loss lie? Matters relating to scienter and aiding and abetting are scope of conduct issues because direct liability and aiding and abetting liability focus primarily upon the relationship that the defendant has with the plaintiff. However, *respondeat superior* and controlling person liability arise out of the relationship that the defendant has with the primary wrongdoer. Aiding and abetting focuses on the defendant's conduct; *respondeat superior* liability turns on the defendant's status. Therefore, the *respondeat superior* matter is properly characterized as an elements of liability issue.<sup>113</sup>

As examples of elements of liability questions, the *Central Bank* majority<sup>114</sup> included issues relating to the proper statute of limitations,<sup>115</sup> the existence of a right to contribution,<sup>116</sup> the existence of a reliance requirement,<sup>117</sup> and the

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<sup>112</sup> See Goodwin, *supra* note 14, at 1417 n.159 (citing W. PAGE KEETON, ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 69, at 499-500 (5th ed. 1984)); see also Miller, *supra* note 14, at 934:

Unlike aiding and abetting and conspiracy, *respondeat superior* does not involve a question of the scope of conduct prohibited under section 10(b). Rather, the principle of *respondeat superior* is "a legal maxim that imposes liability on one if another in their relationship has committed a violation of a certain code of conduct."

*Id.*

<sup>113</sup> See *In re Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1468 (N.D. Ill. 1996) (drawing the same distinction under the Commodities Exchange Act: "respondeat superior is merely a means of imputing the liability of an agent to its principal; in contrast, the plaintiffs here ask us to recognize a private cause of action that reaches all who merely aid or abet a CEA violator.").

<sup>114</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 172 (1994).

<sup>115</sup> *Id.* (citing *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 355 (1991)).

<sup>116</sup> *Id.* (citing *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 290-94 (1993)).

<sup>117</sup> *Id.* (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-49 (1988)).

availability of an *in pari delicto* defense.<sup>118</sup> The issue of contribution arises in cases where violations have been established and the question becomes where the loss should lie. The statute of limitations becomes an issue where violations have been established or assumed, and the question becomes whether the loss should be left with plaintiffs because they were tardy in filing suit.<sup>119</sup> *Respondeat superior* becomes an issue in similar circumstances (after a violation of section 10(b) and Rule 10b-5 is established or assumed) and answers similar questions (regarding where the loss caused by the violation should lie).<sup>120</sup>

To return to the contribution comparison, rules of contribution answer the question: Between two guilty parties, where should the loss lie? *Respondeat superior* and other agency theories address the question: Between two innocent parties, the unknowing principal and the defrauded plaintiff, where should the loss lie?

Thus, to return to Fischel's scienter argument posed above, one author made the point several years ago that:

[A]pparent authority and respondeat superior are simply means for allocating loss between two innocent parties. Seen in this light, agency theories should not be operative in determining whether a securities violation was committed, but rather, should function only to allocate loss after the initial finding of violation has been made.<sup>121</sup>

Ultimately, it probably matters little as to which side is more persuasive in this little debate-within-a-debate. The *Central Bank* majority drew this artificial boundary in order to stress the point that although resolution of questions falling in the second category (elements of liability) requires the Court "to infer how

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<sup>118</sup> *Id.* (citing *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315-19 (1985)).

<sup>119</sup> See generally Christopher R. Leslie, *Den of Inequity: The Case for Equitable Doctrines in Rule 10b-5 Cases*, 81 CAL. L. REV. 1587, 1590-91 (1993) (explaining various policy grounds for allowing guilty defendant to escape liability on statute of limitations defense).

<sup>120</sup> The same parallels can be drawn between *respondeat superior* liability and the other two specific examples given by the Supreme Court—reliance and the *in pari delicto* defense. Both become an issue after a Rule 10b-5 violation is established, and both address the question of where the loss caused by the violation should lie. In *Basic*, 485 U.S. at 243, the Supreme Court held, in part, that the injury caused by defendant's Rule 10b-5 violation must remain with plaintiff if plaintiff cannot prove reliance. In *Bateman*, 472 U.S. at 306-11, the Supreme Court held, in part, that an injury caused by defendant's Rule 10b-5 violation must remain with plaintiff if plaintiff helped create the violation.

<sup>121</sup> J. Michael Gottesman, *Brokers' Derivative Liability: Does Supervision Make a Difference?*, 41 BROOK. L. REV. 181, 207 (1974).

the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act,”<sup>122</sup> questions in the first category (scope of conduct) are answered solely by the text of the statute.<sup>123</sup> Nonetheless, in deciding the first category issue presented in *Central Bank*, the Court did what it normally does, and should do, in such cases—pay lip service to the controlling nature of the statutory language and then proceed to (a) attempt to infer what the 1934 Congress would have wanted by analyzing other provisions in the 1934 Act, (b) examine evidence of legislative intent,<sup>124</sup> and (c) discuss policy implications.

*Central Bank* implies that there is no need to look at the language of the statute in an elements of liability issue, presumably because there will be no guidance there.<sup>125</sup> This conclusion, however, is clearly erroneous. The language of the statute can give useful guidance as to both types of issues, as the next section’s discussion illustrates.

## B. Statutory Language

It is now a given that statutory language is “[t]he starting point in every case involving construction of a statute.”<sup>126</sup> The *Central Bank* majority began its analysis by noting that nothing in the language of section 10(b) mentions aiding and abetting, a fact that “bode[d] ill” for plaintiffs.<sup>127</sup> Similarly, the words *respondeat superior* do not appear in section 10(b). However, further analysis of the text of section 10(b) is revealing.

### 1. “Directly or Indirectly”

Section 10(b) initially provides that it is unlawful for any person “directly or indirectly” to engage in the prohibited fraudulent or manipulative acts. What meaning is to be accorded the words “directly or indirectly”? One plausible

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<sup>122</sup> *Central Bank*, 511 U.S. at 173 (quoting *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993)).

<sup>123</sup> *See id.* at 177.

<sup>124</sup> For example, in his study of the Supreme Court’s use of legislative history in interpreting the federal securities laws, Quinn found that the Court used legislative history in both *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) (for “ornamental” purposes) and in *Basic*, 485 U.S. at 245–46 (for substantive purposes). Quinn, *supra* note 58, at 266, 269.

<sup>125</sup> *See Central Bank*, 511 U.S. at 173.

<sup>126</sup> *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976), which quotes *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).

<sup>127</sup> *Id.* at 175.

argument is that these words indicate that Congress meant to reach not only those who personally commit the fraudulent acts, but also their principals who act “indirectly” through the wrongdoing agents. Agency principles such as *respondeat superior* would be a natural mechanism for reaching those principals.

The majority opinion in *Central Bank* indicates that the Supreme Court will not necessarily accept this interpretation. Although *Central Bank* never assigned a meaning to the words “directly or indirectly,” leaving open the possibility that the majority Justices might support a *respondeat superior* theory, it did make clear the majority’s belief that aiding and abetting was not covered by stating that “[t]he problem, of course, is that aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do.”<sup>128</sup>

Reworded to fit the *respondeat superior* issue, the *Central Bank* majority opinion might read that “the problem, of course, is that *respondeat superior* liability extends beyond persons who engage, even indirectly, in a proscribed activity; *respondeat superior* liability reaches persons who do not engage in the proscribed activities at all, but who are merely principals of those who do.”

The logic of *Central Bank* does indeed seem to argue for elimination of *respondeat superior* liability. The difficulty for anyone making this argument, of course, is that it leaves the words “or indirectly” completely devoid of meaning, which is hardly proper statutory construction.<sup>129</sup> The *Central Bank* majority announced what “or indirectly” does not mean, but did not hint at what it does mean.<sup>130</sup> *Central Bank of Denver*’s reply brief did in fact argue that the “indirectly” language was simply Congress’s method of making corporations responsible for the actions of their agents,<sup>131</sup> and Justice Breyer

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<sup>128</sup> *Id.* at 176.

<sup>129</sup> *Cf. American Textile Mfr. Inst., Inc. v. Donovan*, 452 U.S. 490, 513 (1981) (noting “well-settled rule that all parts of a statute, if possible, are to be given effect”); *Association of Bituminous Contractors, Inc. v. Andrus*, 581 F.2d 853, 862 (D.C. Cir. 1978) (interpreting Federal Coal Mine Health and Safety Act of 1969 in a way that gave meaning to the terms “lessee” and “owner”) (citing 2A JABEZ GRIDLEY SUTHERLAND, STATUTORY CONSTRUCTION, § 46.06 (4th ed. 1973)).

<sup>130</sup> A second reason that the *Central Bank* majority rejected the “directly or indirectly” argument is that there are other provisions of the 1934 Act that use the term in a way that does not necessarily impose aiding and abetting liability, so its use in section 10(b) does not do so either. *See Central Bank*, 511 U.S. at 176 (citing various sections of the 1934 Act: 15 U.S.C. § 78g(f)(2)(C) (1994); 15 U.S.C. § 78i(b)(2)-(3) (1994); 15 U.S.C. § 78m(d)(1) (1994); 15 U.S.C. § 78p(a) (1994); 15 U.S.C. § 78t (1994)). This argument is not directly relevant to the *respondeat superior* issue.

<sup>131</sup> *See Reply Brief for Petitioner at 2, Central Bank of Denver v. First Interstate Bank*

took the same view when he sat on the First Circuit.<sup>132</sup> Although there is no direct evidence that this is the case, if one eliminates the possibility, as the *Central Bank* majority did, that the "or indirectly" language refers to aiding and abetting liability, then *respondeat superior* is the most plausible remaining explanation for Congress's inclusion of these words in section 10(b).<sup>133</sup>

Fischel has suggested that a plausible interpretation of the "or indirectly" language is that it can be used to impose liability upon a defendant even though that defendant does not himself use the jurisdictional means, such as mailing a letter in interstate commerce.<sup>134</sup> In so doing, he cited Professor Jacobs's treatise on Rule 10b-5.<sup>135</sup> Fischer and Jacobs both buried this purported interpretation in footnotes, perhaps because the phrase "directly or indirectly" clearly modifies subsection (b)'s "[t]o use or employ . . . any manipulative or deceptive device" language.<sup>136</sup> The drafters clearly meant the words "by use of any means or instrumentality of interstate commerce or of the mails" as a second modifier that also modifies the "to use or employ" language.<sup>137</sup> By any careful reading, the first modifier ("directly or indirectly") modifies the provision's main language ("[t]o use or employ"); it does not modify the second modifier ("by the use of . . . interstate commerce").

## 2. "Person"

One term in the text of section 10(b) that was not discussed in *Central Bank* is the word "person." The statute prohibits any "person" from committing fraudulent or manipulative acts. Why is that important? The word "person" is defined for purposes of the 1934 Act in section 3(a)(9) to include any

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of Denver, 511 U.S. 164, 172 (1994) (No. 92-854).

<sup>132</sup> *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 32 (1st Cir. 1986) ("There are strong reasons for believing that the 'direct or indirect' language of the Securities Act encompasses this kind of common law agency liability.").

<sup>133</sup> See *Musewicz*, *supra* note 7, at 778 ("A reasonable interpretation . . . is that an employer who employs someone who commits a securities fraud in violation of the 1934 Act has indirectly violated Rule 10b-5.").

<sup>134</sup> Fischel, *supra* note 11, at 94 n.83.

<sup>135</sup> ARNOLD S. JACOBS, *THE IMPACT OF RULE 10B-5*, § 3.02(f) n.33 (1980).

<sup>136</sup> 15 U.S.C. § 78j(1)(b) (1994).

<sup>137</sup> Of course adverbs are often used to modify other adverbs. H. RAMSEY FOWLER, *THE LITTLE BROWN HANDBOOK* 198 (2d ed. 1983). However, if Congress had intended "directly or indirectly" to modify "by the use of any means or instrumentality of interstate commerce," it probably would have worded the provision in the following fashion: It shall be unlawful for any person by the use, directly or indirectly, of any means or instrumentality of interstate commerce.

"company."<sup>138</sup> A company is an artificial entity.<sup>139</sup> It has no "soul to damn" nor "pants to kick."<sup>140</sup> It cannot physically commit fraudulent or manipulative acts. It can be liable only on a *respondeat superior* or some other agency basis for the fraudulent and manipulative acts of its agents.<sup>141</sup> In so defining this term, Congress clearly indicated that artificial entities can be liable under section 10(b) and other 1934 Act provisions.<sup>142</sup> By using the word "person" and defining that word to include "company," Congress necessarily put its stamp of approval upon use of *respondeat superior* liability and related agency theories in section 10(b) and Rule 10b-5 cases.<sup>143</sup> The presence of the term "person" was irrelevant to the *Central Bank* inquiry regarding aiding and abetting liability, but it provides a powerful argument for *respondeat superior* liability. In other words, there is no reason why an inquiry regarding one form of secondary liability (aiding and abetting) need lead to the same result regarding a different form of secondary liability (*respondeat superior*).

The Supreme Court's decision in *United States v. A & P Trucking Co.*<sup>144</sup>

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<sup>138</sup> See 15 U.S.C. § 78c(a)(9) (1981).

<sup>139</sup> "Company" is defined as "[u]sually, but not necessarily, a corporation, since the word is inclusive of natural persons; a union of two or more persons for business; a partnership; a corporation; an association; a joint stock company." *BALLENTINE'S LAW DICTIONARY* 232 (3d ed. 1969). Thus, the term "company" can include natural persons, but more typically refers to artificial entities.

<sup>140</sup> H.L. MENCKEN, *A NEW DICTIONARY OF QUOTATIONS ON HISTORICAL PRINCIPLES FROM ANCIENT AND MODERN SOURCES* 223 (1942) ("A corporation is a legal fiction [with] no pants to kick or soul to damn and, by God, it ought to have both!").

<sup>141</sup> In an earlier article, see Prentice, *supra* note 17, at 6, the author assumed that when a company was held liable for a fraudulent statement issued in its name that its liability was "primary," as distinguished from the "secondary" liability of aiding and abetting. The distinction drawn between the primary liability discussed in that article and aiding and abetting liability is based on conduct. The usage of "primary" is similar to that of the court in *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978).

However, it is impossible for a company that does not exist in physical reality to issue any statement. Its liability is, of necessity, secondary liability that arises from its *status* as principal of the wrongdoing agents. Failure to distinguish between these two concepts of "secondary" liability can cause confusion. See *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 182 n.8 (3d Cir. 1981).

<sup>142</sup> *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986) ("by explicitly including corporations in its definition of 'person,' . . . the statute seems to foresee that corporations will be held liable").

<sup>143</sup> See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975) ("Congress evidently intended that a corporation might be liable in some instances as a 'person'; and this can only be by virtue of agency principles, since a corporation can act only through its agents.").

<sup>144</sup> 358 U.S. 121 (1958).

provides useful guidance. In that case, two partnerships were charged with violations of a statute that made it criminal knowingly to violate ICC regulations for the safe transportation of "explosives and other dangerous articles,"<sup>145</sup> just as section 10(b) makes it a civil violation knowingly to violate SEC rules. In response to the claim that partnerships could not "knowingly" violate any provision, the Supreme Court pointed out that, as in the 1934 Act, Congress in the Motor Carrier Act defined "person" to include a "copartnership" and held that this clearly indicated that Congress intended organizations such as partnerships to be held criminally liable:

It is argued that the words "knowingly" and "knowingly and willfully" by implication eliminate partnerships from the coverage of the statutes, because a partnership, as opposed to its individual partners, cannot so act. But the same inability so to act *in fact* is true, of course, with regard to corporations and other associations; yet it is elementary that such impersonal entities can be guilty of "knowing" or "willful" violations of regulatory statutes through the doctrine of *respondeat superior*.<sup>146</sup>

Thus, although the business entity could not truly violate the law in a "knowing" way, Congress's decision to define a "person" potentially liable under the act to include "copartnerships" meant that the partnership could be held liable on a *respondeat superior* basis "quite apart from the participation and knowledge of the partners as individuals."<sup>147</sup> The strong parallels to *A & P Trucking* virtually mandate a similar outcome in the section 10(b) and Rule 10b-5 setting.<sup>148</sup>

Even the *Central Bank* majority opinion noted, albeit indirectly, that *respondeat superior* liability is appropriate in a post-*Central Bank* world:

The absence of Sec. 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) [may be liable if all elements of a Rule 10b-5 claim are present].<sup>149</sup>

Again, such artificial creatures as "entities" or "banks" can be liable only

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<sup>145</sup> *Id.* at 121-22 (citing 18 U.S.C. § 835 (1948)).

<sup>146</sup> *Id.* at 125 (second emphasis added) (citations omitted).

<sup>147</sup> *Id.* at 126-27.

<sup>148</sup> The Court's holding in *A & P Trucking* clearly deals yet another blow to Fischel's claim that *Hochfelder's* scienter requirement is inconsistent with imposition of *respondeat superior* liability. See *supra* notes 75-78 and accompanying text.

<sup>149</sup> *Central Bank*, 511 U.S. at 191 (emphasis added).



on a *respondeat superior* or some other agency basis given that they do not exist in physical reality to defraud or manipulate. *Respondeat superior* liability must exist for this part of the Supreme Court's opinion to make any sense.

SEC interpretations regarding a statute it is charged with administering are entitled to deference,<sup>150</sup> and the SEC has long applied *respondeat superior* under section 10(b) and Rule 10b-5.<sup>151</sup> More importantly, the Supreme Court itself has repeatedly decided section 10(b) and Rule 10b-5 cases where the defendants were entities that could be held liable only on agency principles. Examples of such cases include the accounting firms in *Hochfelder*<sup>152</sup> and *Huddleston*;<sup>153</sup> the law firms in *Musick, Peeler*<sup>154</sup> and *Gilbertson*;<sup>155</sup> the stock brokerage firm in *Bateman*, *Eichler*;<sup>156</sup> the insurance company in *Bankers Life & Casualty*;<sup>157</sup> the miscellaneous corporations in *Blue Chip Stamps*,<sup>158</sup> *Santa Fe Industries*,<sup>159</sup> and *Basic*;<sup>160</sup> and the banks in *Affiliated Ute*<sup>161</sup> and in *Central Bank* itself. In *Affiliated Ute*, for example, the Supreme Court stated that "[t]he liability of the bank, of course, is coextensive with that of [its agents] Gale and Haslem,"<sup>162</sup> again enunciating the viability of the *respondeat superior* theory.<sup>163</sup>

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<sup>150</sup> See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984) (holding that courts should defer to agencies' interpretations of the statutes they administer if (i) the statutory language does not definitively decide the issue, and (ii) the agency's interpretation is not manifestly unreasonable. This approach is now known as the "Chevron doctrine," but it predated that decision as a simple rule of statutory construction.). See 2A C. DALLAS SANDS, SUTHERLAND STATUTORY CONSTRUCTION § 49.05 (4th ed. 1973). The Supreme Court paid this doctrine scant attention in the *Central Bank* case, see Stern, *supra* note 23, at 27-28, but had followed it in earlier securities cases involving the Investment Company Act. See *United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 719 (1975); *E.I. duPont de Nemours v. Collins*, 432 U.S. 46, 54-55 (1967).

<sup>151</sup> See, e.g., *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961); *H.F. Schroeder & Co.*, 27 S.E.C. 833, 837 (1948).

<sup>152</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>153</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983).

<sup>154</sup> *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286 (1993).

<sup>155</sup> *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

<sup>156</sup> *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

<sup>157</sup> *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

<sup>158</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

<sup>159</sup> *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

<sup>160</sup> *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>161</sup> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

<sup>162</sup> *Id.* at 154.

<sup>163</sup> In *Blau v. Lehman*, 368 U.S. 403, 409-14 (1962), the Supreme Court assumed the applicability of agency principles for imposing liability under another 1934 Act provision, section 16(b), but did not find the factual requisites to be present in that case. See 15 U.S.C.

One might, of course, argue that the *respondeat superior* issue was not directly raised by any of the parties in those cases, but there are two obvious rejoinders. First, the fact that the issue was not raised in any of those cases indicates that the availability of *respondeat superior* liability is so logical and so natural that it has been presumed with little question.<sup>164</sup> Second, the Supreme Court demonstrated in *Central Bank* itself that it is fully capable of changing law that it dislikes regardless of whether or not the parties raised the issue themselves.<sup>165</sup>

### C. Analogous Statutory Provisions

Whether the *respondeat superior* question is an elements of liability issue, where analysis begins with an attempt to infer what the 1934 Congress would have intended, or a scope of conduct issue, where analysis begins and theoretically ends with statutory interpretation (but inevitably proceeds further), the next stage for this Article is to explore analogous securities law provisions in an attempt to “infer ‘how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.’”<sup>166</sup>

In undertaking this examination to establish the elements of liability for the section 10(b) and Rule 10b-5 cause of action, the Supreme Court in *Musick, Peeler* set out the following three goals: (1) “to ensure the action does not conflict with Congress’ own express rights of action,”<sup>167</sup> (2) “to promote clarity, consistency, and coherence for those who rely upon, or are subject to, 10b-5 liability,”<sup>168</sup> and (3) “to effect Congress’ objectives in enacting the

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§ 78p(b) (1981).

<sup>164</sup> See *supra* notes 41–42.

<sup>165</sup> As Justice Stevens noted in his dissent,

instead of simply addressing the questions presented by the parties, on which the law really was unsettled, the Court *sua sponte* directed the parties to address a question on which even the petitioner justifiably thought the law was settled, and reaches out to overturn a most considerable body of precedent.

*Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 194–95 (1994) (Stevens, J., dissenting).

<sup>166</sup> *Id.* at 178 (quoting *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993)).

<sup>167</sup> *Musick, Peeler*, 508 U.S. at 295 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976)).

<sup>168</sup> *Id.* (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737–744 (1975)).

securities laws.”<sup>169</sup> This section examines the statutory scheme with these objectives in mind.

### 1. *Conflict with Congress’s Own Express Rights of Action*

The most obvious question in this area is whether recognition of *respondeat superior* liability under section 10(b) and Rule 10b-5 would conflict with section 20(a)’s controlling person provision. It clearly would if section 20(a) is to be the sole means of imposing secondary liability under the 1934 Act. That critical issue is reserved for full discussion in Part III. Here, analysis focuses upon other relevant express liability provisions.

The *Central Bank* majority concluded that because the express causes of action in the 1933 and 1934 Acts did not explicitly impose aiding and abetting liability, Congress would not have done so with section 10(b) either.<sup>170</sup> However, the tale is quite different regarding *respondeat superior* liability. For example, section 9(a) of the 1934 Act imposes liability upon any “person” who manipulates stock prices.<sup>171</sup> Section 18(a) imposes liability upon any “person” who makes misleading statements in filed documents.<sup>172</sup> Because for both provisions the term “person” is defined in section 3(a)(9) as including companies that can be liable only on an agency basis, it appears that Congress in 1934 did impose *respondeat superior* liability under these other provisions. Therefore, one may infer that had they had the option, the 1934 senators and representatives would have intended *respondeat superior* liability to apply in an express section 10(b) cause of action.<sup>173</sup>

*Respondeat superior* liability has been routinely applied in both section 9(a)<sup>174</sup> and section 18(a)<sup>175</sup> over the years, as well as under the express liability

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<sup>169</sup> *Id.* (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477–78 (1977)).

<sup>170</sup> See *Central Bank*, 511 U.S. at 179.

<sup>171</sup> 15 U.S.C. § 78i (1981).

<sup>172</sup> 15 U.S.C. § 78r (1981).

<sup>173</sup> Admittedly this argument entails some bootstrapping based on the arguments made in Part II(B)(2). See *supra* notes 138–65 and accompanying text.

<sup>174</sup> See, e.g., *Sennott v. Rodman & Renshaw*, 474 F.2d 32, 37–38 (7th Cir. 1973) (defendant brokerage firm would be held liable for section 9(a) violation on agency principles had wrongdoer had real or apparent authority, but he did not); *R.J. Koeppe & Co. v. SEC*, 95 F.2d 550, 552–53 (7th Cir. 1938) (brokerage firm enjoined for section 9(a) violation).

<sup>175</sup> See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545, 551–52 (2d Cir. 1979) (corporation held potentially liable under section 18(a)); *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 457 (2d Cir. 1968) (same); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 788–89 (2d Cir. 1951) (same); *In re Equity Funding Corp. of Am. Sec. Litig.*, 416 F. Supp. 161, 191 (C.D. Cal. 1976) (accounting firm held potentially liable).

In many other section 18(a) cases courts exonerated defendants from liability for one

provisions of the 1933 Act.<sup>176</sup> It would be inconsistent to read such liability out of section 10(b) alone.

## 2. Clarity, Consistency, and Coherence for Those Who Rely Upon, or Are Subject to, Rule 10b-5 Liability

Recognition of *respondeat superior* liability for the section 10(b) and Rule 10b-5 cause of action promotes the clarity, consistency, and coherence desired by the Supreme Court. It does so by conforming the rules of vicarious liability under these provisions to the practices that are virtually universal in other areas of Western law.

As noted earlier, the *respondeat superior* doctrine is ubiquitous in American law, both state<sup>177</sup> and federal.<sup>178</sup> It is, indeed, widely recognized in the entire Western legal world because it serves many important purposes of the law.<sup>179</sup> It is so well affixed in the federal law in general and in the law of

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reason or another, but clearly assumed the applicability of *respondeat superior* liability in proper circumstances. *See, e.g., In re Penn Central Sec. Litig.*, 494 F.2d 528 (3d Cir. 1974) (corporate defendant); *Lindner Dividend Fund v. Ernst & Young*, 880 F. Supp. 49 (D. Mass. 1995) (accounting firm defendant); *Kennedy v. Chomerics, Inc.*, 669 F. Supp. 1157 (D. Mass. 1987) (corporate defendant); *Dewitt v. American Stock Transfer Co.*, 433 F. Supp. 994 (S.D.N.Y. 1977) (corporate defendant); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976) (accounting firm defendant); *Weisfeld v. Spartans Indus.*, 58 F.R.D. 570 (S.D.N.Y. 1972) (retail store operator defendant). In none of these cases did any court hint that a corporation would not be responsible for the fraudulent acts of its employees or that an accounting firm would not be responsible for the fraudulent acts of its auditors.

<sup>176</sup> *See infra* notes 350–59 and accompanying text.

<sup>177</sup> *See, e.g., Arbour v. Jenkins*, 903 F.2d 416, 422 (6th Cir. 1990) (applying Michigan law, principal is responsible for intentional acts of agent within scope of employment); *Hodges v. Gibson Products Co.*, 811 P.2d 151, 156 (Utah 1991) (principal is liable for agent's intentional torts); *Effort Enterprises, Inc. v. Crosta*, 391 S.E.2d 477, 479 (Ga. Ct. App. 1990) (same); *Country Roads, Inc. v. Witt*, 737 S.W.2d 362, 364 (Tex. App. 1987) (principal is liable for punitive damages generated by agent's fraud).

<sup>178</sup> *See Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980) ("Limiting secondary liability under the 1934 Act to that liability provided by section 20(a) would contradict the pervasive application of agency principles in nearly all other areas of the law."); *see also* Barbara Black, *Application of Respondeat Superior Principles to Securities Fraud Claims Under the Racketeer Influenced and Corrupt Organizations Act (RICO)*, 24 SANTA CLARA L. REV. 825, 837 (1984) ("There is a general judicial acceptance for applying common law agency principles to federal statutes.").

<sup>179</sup> Professor Conard has recently charted the "triumph" of *respondeat superior* in the legal systems of the Western world. *See Alfred F. Conard, Enterprise Liability and Insider Trading*, 49 WASH. & LEE L. REV. 913, 915–17 (1992) [hereinafter Conard, *Enterprise Liability*].

securities specifically that Professor Conard noted the startling peculiarity of a provision of the Insider Trading Securities Fraud Enforcement Act of 1988,<sup>180</sup> which provided that employers would not be liable for insider trading offenses of their employees if they acted in good faith and did not induce the violation.<sup>181</sup> This provision struck a discordant note because it "rejected not only the rules of liability that most federal courts had applied under the principal securities Acts, but also a centuries-old tradition of the common law of torts."<sup>182</sup> Any attempt to eliminate *respondeat superior* liability under section 10(b) and Rule 10b-5 should be just as disquieting.

The Supreme Court has faced a nearly identical issue in construing the antitrust laws. Those laws also do not explicitly provide for *respondeat superior* liability, yet the Court held in *American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*<sup>183</sup> that agency principles are applicable because "[t]he apparent authority theory has long been the settled rule in the federal system,"<sup>184</sup> citing at least two securities law cases in so ruling.<sup>185</sup> The Court so ruled in a particularly unappealing setting where (a) defendant was a nonprofit organization,<sup>186</sup> (b) the antitrust law's punitive treble damages provision was applicable,<sup>187</sup> and (c) the agent's act did not benefit the principal in any way.<sup>188</sup>

Corporations, law firms, accounting firms, and underwriting firms would be surprised, though no doubt pleased, to learn that although they are liable for the torts of their agents under common law, under most nonsecurities federal statutes, and under virtually all other federal securities provisions, strangely they are not liable for the torts of their agents under section 10(b) or Rule 10b-5. Such an incongruity would be shocking.

Those who rely upon section 10(b) and Rule 10b-5 to protect them from securities fraud would be similarly startled by such a state of affairs. They rely upon the doctrine of *respondeat superior* to impose liability upon the employers of the agents with whom they deal under the common law, under other federal statutes, and under other federal securities laws. Why, they might well wonder,

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<sup>180</sup> Pub. L. No. 100-704, 102 Stat. 4677 (1988).

<sup>181</sup> 15 U.S.C. § 78t-1(b)(3) (1994).

<sup>182</sup> Conard, *Enterprise Liability*, *supra* note 179, at 913.

<sup>183</sup> 456 U.S. 556 (1982).

<sup>184</sup> *Id.* at 567.

<sup>185</sup> *Holloway v. Howerdd*, 536 F.2d 690, 695 (6th Cir. 1976) ("The Securities Acts were not intended to preempt the operation of the doctrine of respondeat superior in a case involving unlawful activities of a brokerage firm's employees."); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 741 (10th Cir. 1974) (holding company liable for the fraud of its principal officer on grounds of apparent authority).

<sup>186</sup> *Hydrolevel*, 456 U.S. at 558 (nonprofit defendant).

<sup>187</sup> *Id.* at 574-76 (applying punitive treble damages).

<sup>188</sup> *Id.* at 573-74 (benefit principal).

should there be an exception under section 10(b) and Rule 10b-5? No logical reason appears.

In its discussion of analogous statutory provisions, the *Central Bank* majority did make the point that reliance is an important element of Rule 10b-5 recovery and plaintiffs should not be allowed to recover from a mere aider and abettor upon whose statements or actions they did not rely.<sup>189</sup> This argument, however, carries no weight in the *respondeat superior* context. Because of the universal and long-standing acceptance of the doctrine of *respondeat superior* in both the legal and business worlds, plaintiffs do and should be allowed to rely upon the principals of those who defraud, both in general and in securities cases specifically.

As will later be developed in more detail,<sup>190</sup> just as a consumer who shops at Sears relies primarily on the company rather than upon the individual salesperson with whom the consumer deals, an investor who walks into the door of Merrill Lynch usually does so in large part because of the reputation of the firm, rather than the reputation of the individual broker to whom she will be assigned. When such an investor is defrauded by the individual broker, naturally she believes that she can hold Merrill Lynch responsible. When an investor reads a certified financial statement prepared by the employees of a Big Six accounting firm, she does not rely upon the expertise of the individual auditors who did the work. Rather, the investor relies upon the reputation for expertise of the firm itself.

Continued recognition of *respondeat superior* under section 10(b) and Rule 10b-5 serves the consistency value not only in terms of comparisons with virtually all other areas of the law but also in terms of section 10(b) and Rule 10b-5 practice for the past fifty years. As noted, *respondeat superior* liability was assumed for approximately thirty years until the *Kamen* decision. Thereafter there was some doubt for a while, but the recognition of *respondeat superior* liability has been the nearly unanimous rule for some time now.

### 3. Effecting Congress's Objectives in Enacting the Securities Laws

The primary purposes animating passage of the 1934 Act, particularly its antifraud provisions such as section 10(b), were elimination of securities fraud and protection of investors from such fraud. And the words of a statute should be viewed as containing "meaning imparted to them by the mischief to be remedied."<sup>191</sup>

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<sup>189</sup> See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180-82 (1994).

<sup>190</sup> See *infra* notes 313-21.

<sup>191</sup> *St. Paul Fire & Marine Ins. Co. v. Barry*, 438 U.S. 531, 545 (1978) (quoting

When President Roosevelt sent to Congress the proposed legislation that eventually evolved into the 1933 and 1934 Acts, he noted: "This is but one step in our broad purpose of *protecting investors* and depositors."<sup>192</sup> After that proposed legislation had been partially enacted in the form of the 1933 Act, the President submitted the remainder that became the 1934 Act, stating that he recommended the legislation "for the *protection of investors*, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation."<sup>193</sup> The primary purpose of the 1934 Act, as stated in the Senate Report, was to eliminate, to the extent possible, fraudulent securities transactions.<sup>194</sup> The Supreme Court has often noted the investor protection policies that indisputably motivated Congress to pass the Securities Exchange Act of 1934.<sup>195</sup>

Within the Act, section 10(b) is a broad, remedial statute,<sup>196</sup> and the case law is clear that it should be flexibly and liberally construed to effectuate its

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Duparquet, Huot & Moneuse Co. v. Evans, 297 U.S. 216, 221 (1936)).

<sup>192</sup> *Federal Securities Act Hearings*, *supra* note 1, at 1 (emphasis added).

<sup>193</sup> 78 CONG. REC. 2264 (Feb. 9, 1934) (message from the president to the Senate) (emphasis added).

<sup>194</sup> See S. REP. NO. 792, 73d Cong., 1-5 (1934); see also *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd* 417 F.2d 147 (7th Cir. 1969) (1934 Act "is directed toward the creation and maintenance of a post-issuance securities market that is free from fraudulent practices.").

<sup>195</sup> See, e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 315 (1985) (noting that objective of securities laws was "protection of the investing public and national economy through promotion of 'a high standard of business ethics'" (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963))); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977) ("10(b) must be read flexibly, not technically and restrictively" and the statute provides a cause of action for any plaintiff who "suffer[s] an injury as a result of deceptive practices touching its sale [or purchase] of securities . . .") (citations omitted); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (stating that the main purpose of the 1934 Act was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*" (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963))); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963) (holding that fundamental purpose of securities laws is "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.").

<sup>196</sup> See *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (observing that section 10(b) is remedial legislation); *McGann v. Ernst & Young*, 102 F.3d 390, 396 (9th Cir. 1996) (Congress had "broad remedial goals" in enacting section 10(b)) (quoting *Pinter v. Dahl*, 486 U.S. 622, 653 (1988)); *Kerbs v. Fall River Indus., Inc.*, 502 F.2d 731, 739 (10th Cir. 1974) (same); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974) (same).

compensatory purposes.<sup>197</sup> The obvious purpose for including a section outlawing the use of manipulative and deceptive devices is to protect investors. Indeed, Congress explicitly so stated in the very words of section 10(b) when it predicated a violation of the provision upon the “contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or *for the protection of investors*.”<sup>198</sup>

Section 10(b) was patterned, in part, upon the common law of fraud and deceit.<sup>199</sup> Congress’s goal in passing the 1934 Act was to ease, not increase, the burdens of defrauded investors seeking recovery.<sup>200</sup> Congress recognized “that the common law and state legislation afforded the public insufficient protection against plain fraud both in the issuance of securities and in postissuance

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<sup>197</sup> See *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (concluding that section 20(b) should receive flexible interpretation); *In re American Continental Corp.*, 49 F.3d 541, 543 (9th Cir. 1995) (noting that section 10(b) should be read flexibly to effect remedial purposes); *Herpich v. Wallace*, 430 F.2d 792, 806 (5th Cir. 1970) (concluding that section 20(b) should receive flexible interpretation).

Admittedly, the Court has also stated that “generalized references” to the 1934 Act’s remedial purposes will not justify reading section 10(b) more broadly than its language and the statutory scheme reasonably permit. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979). However, if one considers the arguments made in this Article from the statutory language and the statutory scheme, the suggested reading (that *respondeat superior* is available) is not only reasonably permitted, it is almost mandated.

<sup>198</sup> 15 U.S.C. § 78j(b) (1994) (emphasis added). The Supreme Court majority left the words “for the protection of investors” out of the statute when quoting it in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 171 (1994). One cannot help but wonder whether this omission was deliberate. The rationale for gutting investor protection in a statute is certainly not strengthened by reminding readers that the statute was passed for the purpose of protecting investors.

<sup>199</sup> See *Harris v. American Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975) (noting that common law fraud concepts undergird securities laws and provide guidance as to their scope and applications); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 855 (2d Cir. 1968) (observing that section 10(b) should be construed to liberalize the common law in order to effectuate its remedial purpose).

<sup>200</sup> See *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (noting that Supreme Court has “eschewed rigid common-law barriers in construing the securities laws”); *Harris v. American Inv. Co.*, 523 F.2d 220, 224 (8th Cir. 1975) (stating that Rule 10b-5 offers greater protection to plaintiffs than does the common law of fraud); *Resort Car Rental System, Inc. v. Chuck Ruwart Chevrolet, Inc.*, 519 F.2d 317, 321 (10th Cir. 1975) (same); *James v. Gerber Products Co.*, 483 F.2d 944, 946 (6th Cir. 1973) (concluding that Rule 10b-5 plaintiff does not face same limits to recovery as common law fraud plaintiff); *Kubik v. Goldfield*, 479 F.2d 472, 476 n.6 (3d Cir. 1973) (holding that to recover under Rule 10b-5, plaintiffs need not prove all elements of common law fraud); *SEC v. Manor Nursing Ctr., Inc.*, 458 F.2d 1082, 1096 (2d Cir. 1972) (same).



trading.”<sup>201</sup> The Supreme Court has concluded that Congress intended provisions such as section 10(b) to “rectify perceived deficiencies in the available common-law protections,”<sup>202</sup> and to add to those protections,<sup>203</sup> in part by substituting a philosophy of full disclosure for the old anti-investor philosophy of *caveat emptor*.<sup>204</sup> For that reason, the most liberal, pro-investor views on the relevant issues should apply.<sup>205</sup> Therefore, it is clearly wrong-headed even to consider construing section 10(b) and Rule 10b-5 as less protective of investors than the common law. *Respondeat superior* liability was available in the pre-1934 state common law<sup>206</sup> and in pre-1934 state blue sky cases.<sup>207</sup> Therefore, failure to recognize it under section 10(b) and Rule 10b-5

<sup>201</sup> 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 27-28 (3d ed. 1989).

<sup>202</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

<sup>203</sup> See *Basic Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988) (“Actions under 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law.”).

<sup>204</sup> See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 171 (1994); *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *McGann v. Ernst & Young*, 102 F.3d 390, 392 (9th Cir. 1996).

<sup>205</sup> See LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 812 (1983). This statement is especially true because as Justice Stevens pointed out in his *Central Bank* dissent:

[S]hortly before the Exchange Act was passed, this Court instructed that such “remedial” legislation should receive “a broader and more liberal interpretation than that to be drawn from mere dictionary definitions of the words employed by Congress.” *Piedmont & Northern R. Co. v. ICC*, 286 U.S. 299, 311 (1932). There is a risk of anachronistic error in applying our current approach to implied causes of action . . . to a statute enacted when courts commonly read statutes of this kind broadly to accord with their remedial purposes and regularly approved rights to sue despite statutory silence.

*Central Bank*, 511 U.S. at 195-96.

<sup>206</sup> See, e.g., *Antinozzi v. A. Vincent Pepe Co.*, 166 A. 392 (Conn. 1933) (noting master is liable for agent’s torts within scope of authority, even if willful); *Trico Coffee Co. v. Clemens*, 151 So. 175 (Miss. 1933) (same); *Ciarmataro v. Adams*, 176 N.E. 610, 612 (Mass. 1931) (same); *Dickerson v. Atlantic Refining Co.*, 159 S.E. 446 (N.C. 1931) (same); *Great Atlantic & Pacific Tea Co. v. Roch*, 153 A. 22 (Md. 1931) (same); *Johnson v. Atlantic Coast Line R. Co.*, 140 S.E. 443 (S.C. 1927) (same); *Son v. Hartford Ice Cream Co.*, 129 A. 778 (Conn. 1925); *American Sec. Co. v. Cook*, 176 S.E. 798 (Ga. Ct. App. 1934) (noting master is liable for agent’s torts within scope of authority, even if willful); *Gulf, C. & S.F. Ry. Co. v. Cobb*, 45 S.W.2d 323 (Tex. Civ. App. 1931) (same).

<sup>207</sup> Artificial entities that could be held liable only on a *respondeat superior* basis were routinely sued under state civil and criminal securities laws in the 1920s and early 1930s. See, e.g., *People v. George Henriques & Co.*, 196 N.E. 304 (N.Y. 1935) (corporation); *Ward v. Home Royalty Ass’n, Inc.*, 50 P.2d 992 (Kan. 1935) (common-law trust); *Stevens v. Rayon*

would move the law in exactly the opposite direction than was intended by Congress, frustrating rather than effectuating Congress's goals in passing the 1934 Act.

#### D. Congressional Intent and Legislative History

The fourth stage of analysis in *Central Bank* arose from the respondents' "broad-based notion of congressional intent."<sup>208</sup> Specifically, it was argued that Congress passed the 1934 Act with "an understanding of general principles of tort law and that aiding and abetting liability was 'well established in both civil and criminal actions by 1934.'"<sup>209</sup> Therefore, the argument went, it should be assumed that Congress intended aiding and abetting liability to be part and parcel of section 10(b) and Rule 10b-5 liability. The *Central Bank* majority rejected this argument on several grounds, most of which do not militate against *respondeat superior* liability.

##### 1. Uncertain Applications

First, the majority opinion noted that aiding and abetting had its roots in the criminal law and even as of today "has been at best uncertain in application."<sup>210</sup> Assuming the accuracy of this characterization, the contrast between aiding and abetting on the one hand and *respondeat superior* on the other is stark. Although *respondeat superior*'s origins are unclear<sup>211</sup> and it may also have had its roots in the criminal law,<sup>212</sup> its availability has been very certain in Western law for a long time.

Wigmore wrote that as early as the late 1200s in English law the split between criminal and civil applications of *respondeat superior* was anticipated.<sup>213</sup> Most of the English cases that provided the genesis of the

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Indus. Corp., 169 A. 717 (N.J. 1934) (corporation); *Moos v. Landowners Oil Ass'n*, 15 P.2d 1073 (Kan. 1932) (common-law trust); *People v. Federated Radio Corp.*, 154 N.E. 655 (N.Y. 1926) (corporation); *Stevens v. Atlantic & Sec. Mut. Ass'n*, 166 A. 295 (N.J. Ch. 1933) (nonprofit corporation).

<sup>208</sup> *Central Bank*, 511 U.S. at 180-81.

<sup>209</sup> *Id.* at 181 (citing Brief for SEC at 10).

<sup>210</sup> *Id.*

<sup>211</sup> Wigmore traced the doctrine's roots to Germanic law while Holmes purported to find those same roots in Roman law. Compare John H. Wigmore, *Responsibility for Tortious Acts: Its History*, 7 HARV. L. REV. 315, 330 (1894), with Oliver W. Holmes, Jr., *Agency (I)*, 4 HARV. L. REV. 345, 349-51 (1891). What is more important for present purposes is when and how concretely the doctrine entered English and American law.

<sup>212</sup> See Wigmore, *supra* note 211, at 330-36.

<sup>213</sup> See *id.* at 335 (Bracton's works indicate that in the late 1200s the master could

modern *respondeat superior* doctrine were decided in the late 1600s and early 1700s.<sup>214</sup> Blackstone expounded upon the doctrine at length in 1765.<sup>215</sup> Notwithstanding Holmes's famous broadside upon the doctrine in the late 1800s,<sup>216</sup> in 1916 Laski was able to note its "universality"<sup>217</sup> and in 1923 Smith noted that it was "now irretrievably rooted in the law of the English speaking countries."<sup>218</sup>

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exonerate himself from criminal liability for his servant's deeds if he had not commanded the wrongful act nor consented to it, but civil liability continued without regard to command or consent).

<sup>214</sup> Laski lamented that the doctrine did not have roots back as far as Richard I, but was able to trace it to 1688. See Harold J. Laski, *The Basis of Vicarious Liability*, 26 YALE L.J. 105, 106 (1916). The most important early decisions approving vicarious liability were *Jones v. Hart*, 90 Eng. Rep. 1255 (1698) (personal injury case) and *Hern v. Nichols*, 90 Eng. Rep. 1154 (1708) (fraud case). See also Young B. Smith, *Frolic and Detour*, 23 COLUM. L. REV. 444, 449 (1923) (*respondeat superior* was well established in English law by 1796).

<sup>215</sup> Blackstone noted:

As for those things which a servant may do on behalf of his master, they seem all to proceed upon this principle, that the master is answerable for the act of his servant, if done by his command, either expressly given, or implied: *nam qui facit per alium, facit per se*. Therefore, if the servant commit a trespass by the command or encouragement of his master, the master shall be guilty of it: not that the servant is excused, for he is only to obey his master in matters that are honest and lawful. If an inn-keeper's servants rob his guests, the master is bound to restitution: for as there is a confidence reposed in him, that he will take care to provide honest servants, his negligence is a kind of implied consent to the robbery; *nam, qui non prohibet, cum prohibere possit, jubet*. So likewise if the drawer at a tavern sells a man bad wine, whereby his health is injured, he may bring an action against the master: for although the master did not expressly order the servant to sell it to that person in particular, yet his permitting him to draw and sell it at all is impliedly a general command . . . We may observe, that in all the cases here put, the master may be frequently a loser by the trust reposed in his servant, but never can be a gainer: he may frequently be answerable for his servant's misbehaviour, but never can shelter himself from punishment by laying the blame on his agent. The reason of this is still uniform and the same; that the wrong done by the servant is looked upon in law as the wrong of the master himself; and it is a standing maxim that no man shall be allowed to make any advantage of his own wrong.

1 WILLIAM BLACKSTONE, COMMENTARIES 429–30, 432 (1765) (quoted in *City of Oklahoma City v. Tuttle*, 471 U.S. 808, 835–36 n.6 (1985) (Stevens, J., dissenting)).

<sup>216</sup> Oliver W. Holmes, Jr., *Agency (II)*, 5 HARV. L. REV. 1, 14–18, 22 (1891) (arguing that much of agency law in general and *respondeat superior* in particular rests upon illogical and inconsistent legal fictions).

<sup>217</sup> Laski, *supra* note 214, at 111.

<sup>218</sup> Smith's entire point was:

As Justice Stevens has observed, long before 1934 “the doctrine of *respondeat superior* was well recognized in the common law of the several States and in England.”<sup>219</sup> It was firmly established in the federal courts as well, even in cases of fraud by the agent,<sup>220</sup> and it was widely applied in the cases applying pre-1933 state blue sky laws,<sup>221</sup> upon which Congress drew in framing the federal securities laws.<sup>222</sup> Similarly, the federal courts, beginning in 1909, have applied the doctrine of *respondeat superior* even in criminal cases, holding corporations liable for the crimes of their employees.<sup>223</sup>

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No legal doctrine has been so generally criticized and yet so generally adhered to by courts as the doctrine of *respondeat superior*. Not only is it now irretrievably rooted in the law of the English speaking countries but it also exists to some extent in the law of Scotland, France, Italy, Germany, Spain, Portugal, Switzerland and other countries.

Smith, *supra* note 214, at 452–53.

<sup>219</sup> City of Oklahoma City v. Tuttle, 471 U.S. 808, 835 (1985) (Stevens, J., dissenting).

<sup>220</sup> See, e.g., National City Bank v. Carter, 14 F.2d 940 (6th Cir. 1926) (holding bank liable for its officer’s assistance to swindlers); Kean v. National City Bank, 294 F. 214 (6th Cir. 1923) (holding bank liable for its officer’s theft of securities); Stewart v. Wright, 147 F. 321 (8th Cir. 1906) (holding bank liable when its president and cashier helped swindlers).

<sup>221</sup> See *supra* note 207. In its hearings leading to passage of the 1933 and 1934 Acts, Congress was provided with a report that clearly indicated that individuals and organizations were the subjects of state blue sky antifraud statutes. “A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act,” contained in *Federal Securities Act Hearings*, *supra* note 1, at 95 (stating that state officials shall have authority to act “whenever it shall appear that any individual or organization has engaged in, or is about to engage in, fraudulent practices in the sale of securities”).

<sup>222</sup> See, e.g., Aaron v. SEC, 446 U.S. 680, 711 (1980) (Blackmun, J., concurring in part and dissenting in part) (“The problem of securities fraud was by no means new in 1933, and many States had attempted to deal with it by enactment of their own ‘blue sky’ statutes. When Congress turned to the problem, it explicitly drew from their experience.”); SEC v. Ralston Purina Co., 346 U.S. 119, 123 (1953) (stating that blue sky laws are “the statutory antecedents of federal securities legislation”); SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946) (using blue sky precedents in order to determine meaning of “investment contract” term in 1933 Act). See generally Douglas E. Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: “Participation” and the Pertinent Legislative Materials*, 15 FORDHAM URBAN L.J. 877, 905 (1987) (“The Uniform [Securities] Act and the blue sky laws remain instructive in 1933 Act interpretation because the initial federal act’s drafters and enactors examined these regulatory antecedents and were influenced by the strengths and weaknesses they perceived.”).

<sup>223</sup> The first Supreme Court case establishing this rule was *New York Central & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 494 (1909). The Court analogized the criminal liability to tort liability in which *respondeat superior* was already well-settled. *Id.* at 493. “It is now well established that in actions for tort the corporation may be held

## 2. No General Civil Statute

A second point noted by the *Central Bank* majority in this connection is that Congress has not enacted a general civil aiding and abetting statute, so there exists no “general presumption that the plaintiff may also sue aiders and abettors.”<sup>224</sup> Rather, Congress has enacted aiding and abetting provisions on a statute-by-statute basis.<sup>225</sup>

It is, of course, true that Congress has not enacted a general *respondeat superior* liability statute either, but the fact remains that *respondeat superior* liability is widely recognized throughout both federal statutes in general and the securities laws specifically. This was the case in 1934<sup>226</sup> and remains so today. This statutory history should be more than sufficient to establish a general presumption that injured investors may sue the principals of defrauding agents notwithstanding that no such general statute has been enacted.

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responsible for damages for the acts of its agent within the scope of his employment.” *Id.*

The federal courts have repeatedly imposed such vicarious criminal liability in cases where intent was an element as well as in regulatory offenses. *See, e.g.,* New York Cent. & Hudson River R.R. v. United States, 212 U.S. 481 (1909); Joplin Mercantile Co. v. United States, 213 F. 926 (8th Cir. 1914), *aff’d* 236 U.S. 531 (1915). The agent’s scienter is imputed to the corporation for purposes of imposing such liability just as it is in civil tort cases. Furthermore, the law recognizes the “collective knowledge” doctrine that imputes to the corporation the total knowledge of all of its agents and will thereby impose liability upon the firm when no single one of its agents had sufficient knowledge to fulfill the intent requirement of the statute. *See, e.g.,* United States v. Bank of New England, NA, 821 F.2d 844, 856 (1st Cir. 1987); United States v. T.I.M.E.-D.C., Inc., 381 F. Supp. 730, 738 (W.D. Va. 1974).

Congress apparently wished to do the same in the 1934 Act because section 32 imposes criminal penalties upon any “person” who willfully violates any provision of the 1934 Act. *See* 15 U.S.C. § 78ff (1994). Not only did Congress define “person” to include a “company” that could act only through its agents and be liable only through *respondeat superior* in section 3(a)(9), *see* 15 U.S.C. § 78c(a)(9) (1994), but it also provided for penalties for situations “when such person is a person other than a natural person . . .” in section 32(a), *see* 15 U.S.C. § 78ff(a) (1994).

<sup>224</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 182 (1994).

<sup>225</sup> *Id.*

<sup>226</sup> *See supra* notes 220, 223 and accompanying text. Just five years before the 1934 Act was passed, the Supreme Court held a principal liable under federal common law on a *respondeat superior* basis for the fraud of its agent, noting “few doctrines of the law are more firmly established or more in harmony with accepted notions of social policy than that of the liability of the principal without fault of his own.” *Gleason v. Seaboard Air Line Ry. Co.*, 278 U.S. 349, 356 (1929).

### 3. Controlling Person Provision

Third, the *Central Bank* majority noted the “controlling person” provision of section 20, stating that when Congress wished to create secondary liability it had no difficulty in doing so.<sup>227</sup> Discussion of this issue is deferred to Part III, except to note that it can just as persuasively be argued that Congress knows how to make a form of liability exclusive if it wishes, but did not do so in section 20. More to the point, given the universal recognition of *respondeat superior* liability in all contexts in 1934 and Congress’s express provision that “companies,” which can be liable only through *respondeat superior* or similar agency theories, are to be liable, these broadsides against aiding and abetting liability carry little weight when launched against *respondeat superior*.

### 4. Uniform Sale of Securities Act

Finally, the *Central Bank* opinion noted that the 1929 Uniform Sale of Securities Act (“USSA”) contained an express private aiding and abetting cause of action as did several state blue sky laws, apparently concluding that the absence of such an express cause of action in the 1934 Act indicates that Congress consciously chose to omit it.<sup>228</sup> This is very thin evidence, and its implications for *respondeat superior* liability are unclear. The USSA did not carry an express *respondeat superior* liability provision, but clearly assumed its applicability. Like the 1934 Act, the USSA defined “person” to include corporations and other types of firms that can be held liable only upon agency principles.<sup>229</sup> It strongly appears that the drafters of the USSA, like the 1934 Congress, simply assumed the applicability of the nearly universal principle of *respondeat superior* liability.

### 5. Congressional Reenactment

One other subject from this portion of the *Central Bank* opinion must be addressed. The Supreme Court often adheres to a previously-established consistent judicial construction of statutory language when that language has

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<sup>227</sup> *Central Bank*, 511 U.S. at 184 (citing *Pinter v. Dahl*, 486 U.S. 622, 650 (1988)).

<sup>228</sup> *Central Bank*, 511 U.S. at 184–85 (citing *Abrams*, *supra* note 222, at 945).

<sup>229</sup> See UNIF. SALE OF SEC. ACT § 1(2) (1930), reprinted in HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS 235 (1990). The USSA’s antifraud provision, section 16(1), imposed joint and several liability upon the “person” making sales violating the act and “every director, officer or agent [who] shall have personally participated or aided in any way in making such a sale.” *Id.*

been reenacted by Congress.<sup>230</sup> However, no such reenactment had occurred in *Central Bank*, and the majority was unconvinced by (a) "oblique references" to aiding and abetting liability in 1983 and 1988 congressional committee reports,<sup>231</sup> or (b) Congress's supposed acquiescence in the judicial recognition of aiding and abetting liability during its various post-1966 amendments to the securities laws,<sup>232</sup> or (c) Congress's failure to enact bills in 1957, 1959, and 1960 that would have amended the securities laws to impose aiding and abetting liability.<sup>233</sup>

These arguments are not of great relevance here. Clearly, Congress has amended the federal securities laws several times after it became apparent that courts would impose *respondeat superior* liability. Congress has not acted to specifically eliminate *respondeat superior* liability under section 10(b). Just as clearly, the Supreme Court has announced that such a fact will not carry much weight.

It is significant, however, that Congress has twice revised the insider trading laws and explicitly eliminated *respondeat superior* in a narrow range of situations. First, in 1984 Congress passed the Insider Trading Sanctions Act ("ITSA"),<sup>234</sup> which, among other things, authorized the SEC to seek treble monetary penalties against inside traders. The law specified that the "controlling person" provision of section 20(a) would not apply to this liability and that "[n]o person shall be liable to a penalty under subsection (a) of this section solely by reason of employing another person who is liable under such subsection."<sup>235</sup>

Second, four years later Congress passed the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"),<sup>236</sup> which did the following three relevant

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<sup>230</sup> See *Keene Corp. v. United States*, 508 U.S. 200, 209-10 (1993).

<sup>231</sup> *Central Bank*, 511 U.S. at 185.

<sup>232</sup> The year 1966 is significant because that is the year that section 10(b) and Rule 10b-5 aiding and abetting liability was first explicitly recognized by the lower courts in *Brennan v. Midwestern Life Ins. Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

<sup>233</sup> *Central Bank*, 511 U.S. at 186-87.

<sup>234</sup> Pub. L. No. 98-376, 98 Stat. 1264 (1984). See generally Daniel L. Goelzer et al., *Insider Trading Legislation: A Review and a Preview*, in *INSIDER TRADING: COPING WITH THE USE & ABUSE OF MARKET SENSITIVE INFORMATION* 239 (Harvey L. Pitt ed., 1985).

<sup>235</sup> See 15 U.S.C. § 78u-1(b)(2) (1994). During the course of the hearings on ITSA, at least one representative indicated approval of *respondeat superior* in federal securities law cases. See *Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 47-48 (1983) (comments of Representative Rinaldo).

<sup>236</sup> Pub. L. No. 100-704, 102 Stat. 4677 (1988).

things: (a) section 5 targeted broker-dealers and investment advising firms, authorizing the SEC to impose fines upon their members who engaged in insider trading and upon the firms themselves as "controlling persons" if certain requirements were met,<sup>237</sup> (b) while preserving all other causes of action including those implied under section 10(b) and Rule 10b-5,<sup>238</sup> section 5 created a new private cause of action for damages on behalf of those who traded contemporaneously with inside traders against those inside traders,<sup>239</sup> (c) because ITSFEA established standards different than those contained in section 20(a) for "controlling persons," section 3 explicitly made the new definition exclusive in this context and excluded liability under both section 20(a) and under *respondeat superior*.<sup>240</sup>

Absent the presumptive availability of *respondeat superior* liability under the federal securities laws, the provisions of ITSA and ITSFEA that expressly excluded such liability would be superfluous. Together, these two congressional

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<sup>237</sup> See 15 U.S.C. § 78t-1 (1994).

<sup>238</sup> See 15 U.S.C. § 78t-1(d) (1994) ("Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this chapter or the availability of any cause of action implied from a provision of this chapter.").

<sup>239</sup> See 15 U.S.C. § 78t-1(a) (1994). This provision was passed to overrule *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), which had held that plaintiffs who had sold at the same time as a misappropriator lacked standing to sue the misappropriator for damages. Congress explicitly provided that this express cause of action for "contemporaneous traders" should not be construed to eliminate other causes of action implied from the 1934 Act. See 15 U.S.C. § 78t-1(d) (1994). Regarding this nonexclusivity provision, "[i]n its Report the Committee recognized that while there clearly are injuries caused by insider trading to others beyond contemporaneous traders, section 10(b), Rule 10b-5 and other relevant provisions of the 1934 Act have sufficient flexibility to recognize and protect any such defrauded person." Theodore A. Levine et al., *Supervisory and Compliance Procedures for Broker-Dealers*, in INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, 234 (Gary Lynch & Arthur F. Mathews eds., 1989) (citing H.R. Rep. No. 910, 100th Cong., 2d Sess. at 17 (1988)).

As Professor Conard has pointed out, ITSFEA's savings provision was not a boilerplate disclaimer but a specific rejection of a draft of the bill that would have made the ITSFEA cause of action exclusive and an invitation by SEC Chairman Ruder for Congress to so provide. Conard, *Enterprise Liability*, *supra* note 179, at 944-45.

<sup>240</sup> Section 3 of ITSFEA provides that:

No person shall be subject to a penalty under this section solely by reason of employing another person who is subject to a penalty under this section, unless such employing person is liable as a controlling person under paragraph (1) of this subsection. Section 20(a) of this title shall not apply to actions under subsection (a) of this section.

15 U.S.C. § 78t-1(b)(3) (1994).



actions indicate that: (a) Congress supports an expansive application of Rule 10b-5,<sup>241</sup> (b) Congress can and does recognize the existence of both section 20(a) controlling person liability and *respondeat superior* liability, but distinguishes one from the other, (c) Congress presumes the general availability of *respondeat superior* liability under the federal securities laws and eliminates it when it wishes to do so, and (d) Congress has implicitly chosen to preserve *respondeat superior* liability except in very narrow situations.

### E. Policy Considerations

Although the Supreme Court has often noted the usefulness of policy considerations in interpreting the federal securities laws,<sup>242</sup> the *Central Bank* majority stated that “[p]olicy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result ‘so bizarre’ that Congress could not have intended it.”<sup>243</sup> Given the analysis of language and structure thus far presented, it is clear that *respondeat superior* liability should be recognized under section 10(b) and Rule 10b-5 unless policy arguments make it clear that such a conclusion would be “bizarre.” Quite the contrary is the case: Policy arguments generally support recognition of *respondeat superior* liability.

#### 1. The Court’s Policy Considerations

##### a. Certainty and Predictability

The *Central Bank* majority cited two major policy considerations in its opinion. First, in evaluating aiding and abetting liability, the Court, without even noting the irony, overturned thirty years of settled precedent, citing a need for “certainty and predictability” in the law.<sup>244</sup> Elimination of *respondeat*

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<sup>241</sup> See *Thel*, *supra* note 23, at 464 n.362 (stating that in ITSFEA “Congress more or less ratified an expansive application of Rule 10b-5”).

<sup>242</sup> See *Pinter v. Dahl*, 486 U.S. 622, 653 (1988) (noting that policy concerns are properly considered in construing federal securities laws); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 695 n.7 (1985) (same); *McGann v. Ernst & Young*, 102 F.3d 390, 396 (9th Cir. 1996) (same).

<sup>243</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 188 (1994) (quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991)).

<sup>244</sup> *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). Despite the Court’s statement, as Professor Cox has noted: “What is most remarkable about [*Central Bank*] is its poor timing. The Supreme Court discarded a doctrine that had not only been accepted by all the circuits but had matured and become predictable, and there was no

*superior* liability would cause an even greater upheaval than did elimination of aiding and abetting liability. The supposed justification for eliminating aiding and abetting liability was that the rules regarding aiding and abetting liability were unclear, leading to uncertainty.<sup>245</sup>

The rules regarding aiding and abetting liability were in fact unclear and varied from jurisdiction to jurisdiction.<sup>246</sup> The availability of and general rules for *respondeat superior* liability, on the other hand, are settled and have been for decades. They display “a remarkable degree of uniformity throughout the entire common law world.”<sup>247</sup> This is not to say that there are not difficult cases on the margin involving application of these rules,<sup>248</sup> but that is hardly grounds for scuttling a foundational rule of law.

### b. *Litigiousness*

The *Central Bank* majority exposed its policy preferences in its second policy argument—that securities litigation is excessive, dangerously vexatious, costly, and perhaps counterproductive.<sup>249</sup> While it can be strongly argued that these problems have been exaggerated,<sup>250</sup> that is not really the issue. Litigiousness implicates primarily the policy question of whether section 10(b) and Rule 10b-5 causes of action should be recognized at all. This implication is not surprising because *Central Bank* and other recent decisions emanating from

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evidence the doctrine had created mischief in its wake.” Cox, *supra* note 49, at 545.

<sup>245</sup> *Central Bank*, 511 U.S. at 188.

<sup>246</sup> See generally Prentice, *supra* note 17, at 51–78 (summarizing various views of the elements of aiding and abetting under section 10(b) and Rule 10b-5).

<sup>247</sup> P.S. ATIYAH, VICARIOUS LIABILITY IN THE LAW OF TORTS v (1967).

<sup>248</sup> Admittedly, many persons believe that those margins are fairly broad and that much of the law of *respondeat superior* is in need of clarification. See, e.g., Verkerke, *supra* note 94, at 290–305. There will always be difficult cases regarding whether an employee was, under particular circumstances, acting within the “scope of authority,” but the proper approach is to attempt to clarify the boundaries of the “scope of authority,” not to simply eliminate the concept. In no other area of the law is *respondeat superior* being eliminated because its elements are too difficult to apply.

<sup>249</sup> *Central Bank*, 511 U.S. at 189.

<sup>250</sup> See, e.g., Seligman, *Central Bank*, *supra* note 14 (concluding that complaints about class action securities litigation have been overblown); Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994) (debunking some myths about securities fraud litigation); Adam F. Ingber, Note, *10b-5 Or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 FORDHAM L. REV. S351, S352 (1993) (“[O]ne of the premises underlying the [proposed securities law] reforms—that Rule 10b-5 encourages frivolous litigation—is dubious at best.”); Baruch Lev, *Disclosure and Litigation*, 37 CAL. MGMT. REV., Spring 1995, 8, 9 (study showing that large stock price declines do not automatically trigger filing of Rule 10b-5 suits).

the Supreme Court, the Seventh Circuit, and other jurisdictions illustrate a conscious attempt to restrict the section 10(b) and Rule 10b-5 cause of action, perhaps because some jurists do not like the litigation it engenders, especially in light of the fact that Congress did not expressly create it. Justice Scalia has admitted as much.<sup>251</sup> Perhaps these jurists should alter their course given that Congress has at least thrice specifically affirmed the existence of the section 10(b) and Rule 10b-5 cause of action in the following situations: (1) in the Insider Trading Securities Fraud Enforcement Act of 1988 (ITSFEA),<sup>252</sup> (2) in its action to restrict the retroactivity of the Supreme Court's statute of limitations decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,<sup>253</sup> and (3) in the Private Securities Litigation Reform Act of 1995 (PSLRA).<sup>254</sup> Especially in the PSLRA, Congress took the existing implied

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<sup>251</sup> See *Virginia Bankshares Inc. v. Sandberg*, 501 U.S. 1083, 1110 (1991) (Scalia, J., concurring):

I recognize that the Court's disallowance . . . of an action for misrepresentation of belief is entirely contrary to the modern law of torts, as authorities cited by the court make plain . . . I have no problem with departing from modern tort law in this regard, because I think the federal cause of action at issue here was never enacted by Congress, . . . and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task.

<sup>252</sup> Pub. L. No. 100-704, 102 Stat. 4677 (1988).

<sup>253</sup> 501 U.S. 350 (1991). In *Gilbertson*, the Supreme Court erased 40 years of law by holding that the Rule 10b-5 statute of limitations should be derived by analogy to other federal securities law provisions rather than by analogy to state antifraud rules, *see id.* at 362, as the Court had intimated in *Holmberg v. Armbrrecht*, 327 U.S. 392, 395 (1946). The limitations period that the Court borrowed from section 13 of the 1933 Act, *see* 15 U.S.C. § 77m (1981), was generally shorter than analogous state law causes of action that, if applied retroactively, would lead to dismissal of cases that were timely under the law at the time of their filing. It was applied retroactively, and Congress acted to reverse that situation. The law passed to limit the retroactive effect is codified at 15 U.S.C. § 78aa-1 (1994). However, that law was later declared unconstitutional by the Supreme Court in *Plaut v. Spendthrift Farm, Inc.*, 514 U.S. 211 (1995). The important point here is that by enacting a law meant to impact the statute of limitation in a section 10(b) and Rule 10b-5 cause of action, Congress clearly sanctioned the existence of that cause of action.

<sup>254</sup> The entire thrust of the PSLRA was to reform litigation brought under various federal securities law provisions, but most importantly section 10(b) and Rule 10b-5. The entire Act was unnecessary unless Congress intended the cause of action to continue to exist. Had Congress opposed the existence of the section 10(b) and Rule 10b-5 cause of action, it could have legislated one sentence: No private cause of action for damages shall be recognized for violations of section 10(b) of the Securities Exchange Act. Instead, Congress labored at length to make the cause of action operate the way the legislators desired in 1995.

cause of action, reformed it to be what Congress wished it to be, and thereby placed an implicit seal of approval upon it.

In *Musick, Peeler*, the Supreme Court conceded that Congress has placed its implicit stamp of approval upon the section 10(b) and Rule 10b-5 cause of action.<sup>255</sup> Therefore, the fact that a cause of action meant to engender litigation does so is not a terribly significant policy consideration. The real issue, given the continued existence of the section 10(b) and Rule 10b-5 cause of action, is whether it should, like most other causes of action in the Western world, carry a *respondeat superior* component.

## 2. Other Policy Considerations

The *Central Bank* opinion conceded that there were relevant policy considerations other than the two it discussed.<sup>256</sup> This concession is true, for the Court ignored the most important relevant policy considerations—the purposes Congress had in mind in enacting the 1934 Act generally and section 10(b) specifically. Three of the most important purposes that Congress had for enacting the Act are the following: (a) compensating defrauded investors, (b) deterring fraud, and (c) advancing market efficiency. These purposes must also be discussed.

### a. Compensating Defrauded Investors

*Respondeat superior* is an obviously pro-victim doctrine that advances the 1934 Act's purpose of compensating defrauded investors in important ways.

#### i. Respondeat Superior Eases the Plaintiff's Burden of Proof

One of the classic rationales for the *respondeat superior* doctrine is that, while firms are often careless in hiring and supervising employees, it is very difficult for plaintiffs injured by the employees to prove that carelessness.<sup>257</sup>

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At a minimum, the PSLRA is a "partial codification" of the implied section 10(b) and Rule 10b-5 cause of action. See Dennis J. Block & Jonathan M. Hoff, *Securities Litigation Reform Law*, N.Y. L.J., Dec. 21, 1995, at 5; Edward Brodsky, *Assessing the Impact of 'Gustafson'*, N.Y. L.J., Mar. 13, 1996, at 3.

<sup>255</sup> The Supreme Court stated in *Musick* that section 78aa-1, which was passed to reverse the retroactive impact of *Gilbertson's* statute of limitations ruling, "treats the 10b-5 action as an accepted feature of our securities laws . . ." *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993).

<sup>256</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994).

<sup>257</sup> See, e.g., ATIYAH, *supra* note 247, at 20 ("in this complex society it is often hard to

*Respondeat superior* obviates the need for a plaintiff to produce such difficult-to-discover evidence.<sup>258</sup> Applied in the section 10(b) and Rule 10-5 context, *respondeat superior* produces the same benefit that justifies its existence in other areas of the law.

This benefit complements nicely the Supreme Court's holding in *Herman & MacLean v. Huddleston*<sup>259</sup> regarding the burden of proof. In rejecting a lower court ruling that plaintiffs in section 10(b) and Rule 10b-5 suits should have to prove their claims by clear and convincing evidence, which is the standard in common-law fraud claims, the Court noted in *Huddleston* that although section 10(b) was patterned after the common-law fraud cause of action, "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry."<sup>260</sup> Thus, a lowering of the standard of proof to the preponderance of the evidence standard was warranted:

The interests of defendants in a securities case do not differ qualitatively from the interests of defendants sued for violations of other federal statutes such as the antitrust or civil rights laws, for which proof by a preponderance of the evidence suffices. On the other hand, the interests of plaintiffs in such suits are significant. Defrauded investors are among the very individuals Congress sought to protect in the securities laws. If they prove that it is more likely than not that they were defrauded, they should recover.<sup>261</sup>

Because the interests of plaintiffs in securities fraud suits are significant and defrauded investors are the very individuals Congress sought to protect in the securities laws, it similarly makes sense that defendants that are subject to *respondeat superior* liability under most other federal statutes, such as antitrust or civil rights laws, should be similarly liable under section 10(b) and Rule 10b-5. It is not as if plaintiffs are getting a free ride. In order to impose liability upon the principal, they still must, consonant with *Hochfelder*, establish *inter alia*,

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identify the individual person responsible for a tortious act . . . [a]nd it is vicarious liability which entitles the plaintiff to say that it suffices if the cause of the accident was some operation under the control of the defendant's servants").

<sup>258</sup> See Martin J. Weinstein & Patricia Bennett Ball, *Criminal Law's Greatest Mystery Thriller: Corporate Guilt Through Collective Knowledge*, 29 NEW ENG. L. REV. 65, 80 (1994) (discussing analogous benefit of criminal liability based on *respondeat superior* given difficulty prosecutors have in proving bad intent of multiple individual members of a corporate entity).

<sup>259</sup> 459 U.S. 375 (1983).

<sup>260</sup> *Id.* at 389 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)).

<sup>261</sup> *Id.* at 390.

that the wrongdoer acted with scienter;<sup>262</sup> that an agency relationship existed; and that the agent was acting within the scope of actual or apparent authority.

Fischel argued from *Hochfelder* that there is to be no liability when a firm's agent commits intentional fraud within the scope of his authority against the firm's customers unless the board of directors knows of the fraud, the knowledge of which can then be imputed to the firm as a controlling person.<sup>263</sup> In addition to the fact, pointed out above, that Fischel necessarily uses the doctrine of *respondeat superior* to impute the board's knowledge to the firm, this rule would render an injured investor's burden of proof unduly burdensome.<sup>264</sup> The *Huddleston* opinion noted that "the difficulty of proving the defendant's state of mind supports a lower standard of proof."<sup>265</sup> Consider cases involving brokers and dealers. It is difficult enough to establish scienter of the agent with whom the plaintiff has dealt; to establish scienter of high level officers of the firm with whom plaintiffs have often not dealt will usually be much more difficult, if not impossible.<sup>266</sup>

The Supreme Court rejected an argument analogous to Fischel's in *Hydrolevel*.<sup>267</sup> The argument was that the nonprofit principal should be liable for the antitrust actions of its agents only if it ratified them. The Court rebuffed

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<sup>262</sup> The *Hochfelder* scienter requirement is especially onerous for plaintiffs giving the stringent pleading requirements imposed by the PSLRA. See generally Norman B. Arnoff, *The Securities Litigation Reform Act of 1995*, N.Y. L.J., Oct. 8, 1996, at 3 (summarizing the PSLRA's heightened pleading standards); Dennis J. Block & Jonathan M. Hoff, *Pleading Fraud After Securities Reform Act*, N.Y. L.J., Mar. 21, 1996, at 5 (same).

<sup>263</sup> Fischel, *supra* note 11, at 107 n.145.

<sup>264</sup> See Carol M. Lynch, Note, *Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a)—Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383 (1982). Lynch states that

Under Professor Fischel's analysis the plaintiff must overcome a virtually insurmountable burden to obtain recovery under the securities acts. How is the plaintiff to prove that a board of directors knew of a lower-level employee's fraud? Indeed, how might a board of directors, particularly one of a large corporation, ever be aware of such activity? Without the availability of respondeat superior, the class of plaintiffs that could sue under Rule 10b-5 would shrink to a size far smaller than the one that the Supreme Court contemplated in *Hochfelder*.

*Id.* at 1411.

<sup>265</sup> *Herman & MacLean*, 495 U.S. at 391 n.30.

<sup>266</sup> It is similarly difficult for plaintiffs to establish the scienter of auditors who have performed an audit and concomitantly more difficult to establish the scienter of the partners or members at the upper echelons of firm management.

<sup>267</sup> *American Soc'y of Mechanical Eng'g, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 573 (1982).

the argument, stating:

[A] ratification rule would have anti-competitive effects, directly contrary to the purposes of the antitrust laws. ASME could avoid liability by ensuring that it remained ignorant of its agents' conduct, and the antitrust laws would therefore encourage ASME to do as little as possible to oversee its agents. Thus, ASME's ratification theory would actually enhance the likelihood that the Society's reputation would be used for anticompetitive ends.<sup>268</sup>

## ii. *Respondeat Superior's "Deep Pocket" Feature Helps Ensure Compensation for Injured Victims*

Imposing *respondeat superior* liability in securities fraud cases in situations where the traditional elements of liability are present helps to ensure compensation for defrauded investors,<sup>269</sup> consistent with the remedial purposes of the federal securities laws.<sup>270</sup> The damages in major securities fraud actions are often quite large; individual defendants will seldom have the funds to

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<sup>268</sup> *Id.* at 573.

<sup>269</sup> Hackett argued long ago that the human desire to repair an injury underlies much of the doctrine of *respondeat superior*. See Frank W. Hackett, *Why is a Master Liable for the Tort of His Servant?*, 7 HARV. L. REV. 107, 111–12 (1893). Baty, after spelling out nine separate grounds for justifying *respondeat superior* (control, profit, revenge, carelessness, identification, evidence, indulgence, danger, satisfaction), several of which are actually irrelevant to the doctrine, concluded that “the real reason for employers' liability is [that] damages are taken from a deep pocket.” THOMAS BATY, VICARIOUS LIABILITY 148–54 (1916).

The compensation rationale for *respondeat superior* is not necessarily rooted solely in a compassionate desire to compensate injuries. It also has a very practical, business-oriented basis. Laski has explained how such a doctrine became more necessary as enterprise grew and became more depersonalized, noting:

In a world where individual enterprise is so largely replaced, the security of business relationships would be enormously impaired unless we had the means of preventing a company from repudiating its servants' torts. The reason is not that companies are well able to pay; for it is not the business of the law to see that a debtor is solvent, but to provide a remedy for admitted wrong.

Laski, *supra* note 214, at 123–24.

<sup>270</sup> See, e.g., *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980) (“It is consistent with the remedial purpose of the federal securities acts to require a brokerage firm that provides an employee with the means to carry out fraudulent practices to pay damages to a victim of those practices when the employee it has chosen acts within the course and scope of his employment.”).

compensate defrauded investors.<sup>271</sup> The fact that plaintiffs injured in securities fraud suits are often large institutional investors does not minimize the importance of this benefit of *respondeat superior* liability, especially if one recalls the "little people" whose interests are served by most institutional investors.<sup>272</sup>

Although it is true that the "deep pocket" rationale for *respondeat superior* liability often leads critics to suggest that corporations are being victimized in some vague fashion, "[f]rom a moral perspective, it may seem fairer to make the enterprise bear the burden in preference . . . to the outsider who has been harmed."<sup>273</sup>

### b. *Detering Fraud*

As noted earlier, the main reason Congress passed the 1934 Act, and especially section 10(b), was to protect investors from fraud and manipulation.<sup>274</sup> It seems intuitively obvious that investor protection purposes

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<sup>271</sup> See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 707 ("We expect that agents apprehended for fraud usually will be judgment proof, because the firm's value (and thus the agent's wealth and ability to satisfy the optimal damages award) declines dramatically when the fraud is revealed.").

<sup>272</sup> For example, 63 million investors have placed \$3.54 trillion in 6,270 mutual funds. See Kevin G. DeMarrais, *Welcome to the World of Mutual Funds*, THE RECORD, Mar. 2, 1997, at B01. Pension funds handling the investments of millions of workers are another major institutional investor.

<sup>273</sup> Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 13 (1980).

Judge Friendly made the same point when he emphasized the ethical elements of *respondeat superior*, noting in *Ira S. Bushey & Sons, Inc. v. United States*, 398 F.2d 167 (2d Cir. 1968), that the doctrine is based "in a deeply rooted sentiment that business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities." *Id.* at 171. See also Barbara White, *Coase and the Courts: Economics for the Common Man*, 72 IOWA L. REV. 577, 627 n.212 (1987) (referring to "the fairness values inherent in *respondeat superior*").

The judgment to favor the innocent victim of the defrauder over the innocent principal of the defrauder is certainly consistent with Congress's judgment in framing the securities laws. See Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 345 (1988) (citing S. REP. NO. 47 at 4-5 (1933)) ("Section 11 is based on the legal principle that if one of two innocent persons must bear the loss, that person should bear it who has the opportunity to learn the truth and has allowed untruths to be published and relied upon.").

<sup>274</sup> See *supra* notes 191-207 and accompanying text.



are advanced when courts recognize *respondeat superior* liability in the section 10(b) and Rule 10b-5 cause of action. The *Central Bank* majority took the position that making the remedy more far-reaching does not necessarily better serve the objectives of the statute.<sup>275</sup> However, there are some clear reasons why the rationale undergirding the near-universal acceptance of *respondeat superior* dovetails nicely with the policies of fraud deterrence. Together these considerations provide persuasive support for *respondeat superior*'s application to section 10(b) and Rule 10b-5.

### i. *Respondeat Superior Induces Greater Care in Selection and Supervision of Agents*

One important rationale underlying *respondeat superior* has traditionally been that it encourages employers and other principals to take care in choosing and supervising their employees and other agents, thus reducing the overall number of accidents and injuries.<sup>276</sup> The Supreme Court itself has noted that a

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<sup>275</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 188 (1994). The Court made this point as an introduction to its discussion of the costs imposed by a broader remedy, including the lack of certainty and the litigiousness. These have already been demonstrated not to be particularly persuasive considerations regarding *respondeat superior* liability. See *supra* notes 244–55 and accompanying text.

<sup>276</sup> See Laski, *supra* note 214, at 113–14 (quoting *Principles of Penal Law*, in 1 JEREMY BENTHAM, COLLECTED WORKS 383):

The obligation imposed upon the master acts as a punishment, and diminishes the chances of similar misfortunes. He is interested in knowing the character, and watching over the conduct of them for whom he is answerable. The law makes him an inspector of police, a domestic magistrate, by rendering him liable for their imprudence.

Laski argues that “[i]f we allow the master to be careless of his servant’s torts we lose hold upon the most valuable check in the conduct of social life.” *Id.* at 106. See also ATIYAH, *supra* note 247, at 16 (“[T]he person in control is the person best placed to take precautions against accidents.”); 5 FOWLER V. HARPER ET AL., *THE LAW OF TORTS* § 26.3, at 15 (2d ed. 1986) (“Pressure of legal liability on the employer therefore is pressure put in the right place to avoid accidents.”); Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1380 (1982) (“[I]n the private sector, enterprise liability produces greater levels of care [than personal liability of agents].”); Richard A. Posner, *An Economic Analysis of Sex Discrimination Laws*, 56 U. CHI. L. REV. 1311, 1332 (1989) (“The most efficient method of discouraging sexual harassment may be by creating incentives for the employer to police the conduct of its supervisory employees, and this is done by making the employer liable.”); White, *supra* note 273, at 627 n.212 (“[R]espondeat superior contains its own aspects of risk reduction [by creating] . . . an incentive for the employer to scrutinize prospective employees for

major justification for the doctrine of *respondeat superior* is "the common-sense notion that no matter how blameless an employer appears to be in an individual case, accidents might nonetheless be reduced if employers had to bear the costs of accidents."<sup>277</sup>

The courts have traditionally believed that "[t]he most effective means for insuring adequate supervision is to impose liability for injury resulting from its absence."<sup>278</sup> There is every reason to believe that this rationale fits most defendants in section 10(b) and Rule 10b-5 cases as well as it fits defendants in the general run of cases where *respondeat superior* liability has long been applied. If they know that *respondeat superior* liability awaits them should their agents commit securities fraud, accounting firms will be more careful in hiring auditors; law firms will be more vigilant in supervising their young associates; and broker-dealers will be more diligent in selecting and monitoring their sales representatives and others.

This is one of the major rationales the Supreme Court used in *Hydrolevel* to impose treble damages antitrust liability upon a nonprofit principal through *respondeat superior*, even though the antitrust laws do not expressly or impliedly provide for such vicarious liability. The Court reasoned that imposition of antitrust liability upon not only the agents but also the principal would advance the cause of avoiding anticompetitive practices:

[I]f . . . ASME is civilly liable for the antitrust violations of its agents acting with apparent authority, it is much more likely that similar antitrust violations will not occur in the future. "[P]ressure [will be] brought on [the organization] to see to it that [its] agents abide by the law. *United States v. A & P Trucking Co.*, 358 U.S. 121, 126 (1958). Only ASME can take systematic steps to make improper conduct on the part of all its agents unlikely, and the possibility of civil liability will inevitably be a powerful incentive for ASME to take those steps. Thus, a Rule that imposes liability on the standard-setting organization—which is best situated to prevent antitrust violations through abuse of its reputation—is most faithful to the congressional intent that the private right of action deter antitrust violations."<sup>279</sup>

Conard points out that, regarding a particular type of wrongdoing under section 10(b) and Rule 10b-5:

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propensities toward safe and responsible behavior.").

<sup>277</sup> *Monell v. New York City Dep't of Social Servs.*, 436 U.S. 658, 693 (1978).

<sup>278</sup> *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 439 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (quoting *Lorenz v. Watson*, 258 F. Supp. 724, 733 (E.D. Pa. 1966)).

<sup>279</sup> *American Soc'y of Mechanical Eng'rs, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 572-73 (1982).

[E]xclusion of enterprise liability surrenders the most powerful weapon for the deterrence of [insider] trading, which is the motivation of employers to prevent their employees from committing it. Employers are far more able than are their customers, unrelated investors, or the SEC to discover what their employees are doing. The deterrent power of laws against [insider] trading depends primarily on how these laws motivate employers to police the activities of their employees.<sup>280</sup>

Although Conard made the point regarding only insider trading, it can be generalized to corporate disclosure violations. Conard has further noted that without *respondeat superior* liability, a profit-maximizing firm is not interested in minimizing its employees' illegal acts but only in minimizing its own liability for employees' illegal acts.<sup>281</sup> Only *respondeat superior* liability can render those interests relatively coextensive.<sup>282</sup>

## ii. *Qualifications*

Although *respondeat superior* liability should reduce the amount of securities fraud by giving employers the incentive to carefully hire, supervise, and monitor their employees, the results will be far from perfect. For example, Croley has argued: "Firms—the complex constellation of actors that compose a firm—exercise at best only imperfect control over their agents."<sup>283</sup> Nonetheless, Croley concludes that even taking into account various psychological and organizational factors that he believes are underrepresented in current tort and corporate law thinking, enterprise liability still represents the most effective system.<sup>284</sup>

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<sup>280</sup> Conard, *Enterprise Liability*, *supra* note 179, at 947.

<sup>281</sup> *Id.* (discussing provisions of the Insider Trading Securities Fraud Enforcement Act of 1988).

<sup>282</sup> The same rationale underlies the federal policy for imposing criminal liability upon principals for the wrongful acts of their agents. *See, e.g.,* John C. Coffee, Jr., *Corporate Criminal Responsibility*, in 1 *Encyclopedia of Crime and Justice* 253, 257 (Sanford H. Kadish ed., 1983) ("[V]icarious [criminal] liability may well be closely related to the criminal law's chief aim of prevention, both by deterring individual offenders and by encouraging the corporation to install incapacitative monitoring controls."); Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 *GEO. L.J.* 1559, 1573 (1990) (noting that corporate criminal liability arguably encourages closer supervision of employee conduct).

<sup>283</sup> Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 *S. CAL. L. REV.* 1705, 1737 (1996).

<sup>284</sup> Croley concludes:

In fact, to the extent that membership in a firm subjects individual decisionmaking

Arlen and Carney argue that in fraud on the market cases,<sup>285</sup> imposing liability solely upon agents probably achieves better deterrence than imposing liability solely upon principals.<sup>286</sup> However, that is not the relevant comparison. The key question is whether agent liability *and* enterprise liability, together, deter fraud better than agent liability alone.<sup>287</sup> They probably do, and more efficiently as well, as will be explained in the next section.

### c. Advancing Market Efficiency

Easterbrook and Fischel have argued that the 1933 and 1934 Acts are all about market efficiency because that is what protects investors.<sup>288</sup> This argument should be turned around—the federal securities laws are all about protecting investors because “[t]he strength and stability of our nation’s

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to various external checks, corporate liability might best promote reasonable decisionmaking on the part of a corporation’s agents. Corporations liable for the behavior of their agents will tend to influence the decisions of those agents. Corporate checks and balances thus will serve to provide ongoing external discipline over individual decisionmaking—through recurrent exposure to care-promoting stimuli—that individuals acting alone are not fully equipped to provide. Even though firms cannot monitor their agents perfectly (to say the least), it seems possible that the palpable and day-to-day influence that a firm would have on its individual agents would curb unreasonable decisionmaking by those agents more than would the prospect of personal tort liability. Or at least that is the question.

*Id.* at 1737–38.

<sup>285</sup> For a general description of the “fraud on the market” theory, adopted by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224, 247 (1988), see Prentice & Langmore, *supra* note 20, at 47–49.

<sup>286</sup> Arlen & Carney, *supra* note 271, at 704–17.

<sup>287</sup> Arlen and Carney set up the false dichotomy based on the notion that employers seldom seek indemnity from employees whose wrongs cause them to sustain vicarious civil liability. *See supra* note 271. However, that does not mean that the recognition of *respondeat superior* liability means that there are no deterrents to agent fraud in the securities law regime. *See infra* notes 301–07 and accompanying text.

<sup>288</sup> Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985). They state: “True, *people* sometimes say that the function of securities law is ‘the protection of investors’ or ‘compensation for wrongs,’ but these are just restatements of the objective of efficient operation of the markets.” *Id.* at 613 (emphasis added). Easterbrook and Fischel perhaps need to be reminded that, among the “people” who have stated that protection of investors is the function of the securities laws, are the 1934 Congress in the text of section 10(b) itself and the Supreme Court in numerous cases. Only an extremely selective reading of the legislative history of the 1933 and 1934 Acts could provide any support for Easterbrook and Fischel’s conclusion.

securities markets depend in large measure on investor confidence in the fairness and efficiency of these markets.”<sup>289</sup> Evidence is clear from other nations that legal regimes that allow investors to be defrauded and permit them no effective recourse are inefficient and often collapse under their own weight.<sup>290</sup> Effective private remedies are essential to investor confidence in the fairness of securities markets, and such confidence is a predicate of efficiency.<sup>291</sup>

Congress recognized this, as the House Report on the 1934 Act stated:

If investor confidence is to come back . . . *the law must advance*. As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and business

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<sup>289</sup> *Statement of Mark J. Griffin before the Sec. Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs*, May 12, 1994, available in LEXIS, News Library, Allnws File, Federal News Service.

<sup>290</sup> See Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. Fin. (forthcoming) (showing in study of forty-nine countries that those with fewer legal investor protections also have smaller and narrower capital markets). This overall study is borne out by experience in specific countries. See, e.g., Dean Calbreath, *Czechs Act to Beef Up Securities Laws, But Some Worry Changes Are Cosmetic*, WALL ST. J., Feb. 7, 1997, at A11A (reporting that Czech Republic is attempting to create an SEC-like agency to improve efficiency of securities market); Tom Hundley, *Always Poor, Albanians Going for Broke in Scam*, CHIC. TRIB., Feb. 3, 1997, at 1 (reporting that collapse of unregulated pyramid schemes left Albania in chaos); *Remarks of Lawrence Summers at the U.S.-Russia Business Council Conference*, Mar. 29, 1995, available in LEXIS, News Library, Allnws File, Federal News Service (“It is axiomatic that without clear securities laws and shareholders’ rights, Russia will not be able to draw in the foreign investment that it needs to prosper.”).

<sup>291</sup> See *Aiding and Abetting Liability Under the Federal Securities Laws: Hearings on the Impact of the Supreme Court’s Decision in Central Bank before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. (1994) (statement of Arthur Levitt, Chairman, SEC); Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 268 (1997) (“The specter of persons reaping benefits from [fraudulent and manipulative] conduct was perceived [by Congress in 1933] to be part of the reason for the erosion of confidence in the securities markets.”); Jorgenson, *supra* note 14, at 667 (“The stability of the United States’ securities markets is dependent in large part on the willingness of the judicial system to maintain investor confidence in the fairness and efficiency of these markets.”); Ramesh K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 62 (1996) (“To the extent that courts do not consistently enforce the [directors’] fiduciary duty of care, investors’ perceived risks increase, and the price they are willing to pay falls.”).

practice recognize and protect that ordinary citizen's dependent position.<sup>292</sup>

### i. *The General Efficiency of Vicarious Liability*

The superior efficiency of a regime of *respondeat superior* is generally recognized, although there is considerable debate in economic circles regarding the matter. Several economic arguments have been made for the efficiency of the *respondeat superior* regime. Among other points, the "least-cost avoider" test has often been used in economic analysis for determining the proper parameters of strict liability. The least-cost avoider is the person who can most efficiently prevent the loss by adjusting his level of care to the most efficient point.<sup>293</sup> There is every reason to believe that the lowest cost-avoiders are the corporations, brokerage firms, and other organizations that hire and supervise the defrauders, rather than members of the investing public.<sup>294</sup> Generally, imposition of *respondeat superior* liability motivates the employer, who "is surely better situated . . . to identify what supervisory precautions are cost-justified."<sup>295</sup>

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<sup>292</sup> H.R. REP. NO. 1383, at 5 (1934) (emphasis added). President Roosevelt had similar concerns. See MICHAEL PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 3 (1970) ("For many New Dealers like Frankfurter, and for Roosevelt himself, financial regulation was central to the New Deal. Making capitalism live up to its pretensions necessitated a restoration of public confidence in the governing symbols and basic currency of the economic order—investment securities.").

<sup>293</sup> See generally GUIDO CALABRESI, *THE COST OF ACCIDENTS* 135-39 (1970); Stephen G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost-Avoider*, 78 VA. L. REV. 1291, 1292-93 (1992).

<sup>294</sup> See James L. Burns, Note, *Pruning the Judicial Oak: Developing a Coherent Application of Common Law Agency and Controlling Person Liability in Securities Cases*, 93 COLUM. L. REV. 1185, 1220 (1993) (arguing that firms, which as a matter of good business practice and SEC regulation must already perform background checks, review all incoming mail, and monitor employees' financial transactions in and out of the firm, are the least-cost avoiders).

Burns's argument is especially true in recent years because of the SEC priority in requiring brokerage firms to supervise their employees properly and punishing them if they do not. See generally Joseph A. Ingrisano & Susan A. Mathews, *After the SEC's Crackdown on In-House Attorneys and Compliance Officers, Broker-Dealers Need to Take Affirmative Steps to Be Sure They Are Within the Law*, NAT'L L.J., June 6, 1994, at B5 (describing SEC crackdown on securities industry supervisors); Michael F. Siconolfi & Jeffrey Taylor, *Brokers Aren't Being Reined In*, WALL ST. J., Mar. 18, 1996, at C1 (reporting on joint SEC/NYSE/NASD report "taking to task" the brokerage industry for failure to adequately supervise); Andrew W. Sidman, *Who's in Charge?*, BUS. L. TODAY, July/Aug. 1995, at 44 (describing regulatory crackdown on securities industry supervisors).

<sup>295</sup> Seiter, *supra* note 7, at 1531 n.98 (concluding that Seavey's suggestion in Warren

In a recent symposium, one expert argued that placing liability solely on agents and not on the principal would be generally ineffective.<sup>296</sup> Another claimed that a system of pure vicarious liability coupled with immunity for the wrongdoing agent would be most efficient because it would avoid a perceived tendency of agents to be overly cautious in order to avoid personal liability.<sup>297</sup>

This is a very interesting debate, but most of it takes place in the context of claims of negligence, where any enthusiasm for *respondeat superior* must be tempered by a concern that it might generate excessive levels of care by the firm. However, section 10(b) and Rule 10b-5 are not a negligence-based cause of action. Section 10(b) remedies fraud, and excessive deterrence of fraud is not a significant concern. As Arlen and Carney have noted, securities fraud "produces substantial social costs and yields no social benefit . . . [and] therefore should be deterred *completely*."<sup>298</sup>

The concept of efficiency entails more than just deciding what system will do the most to reduce the number of acts of fraud, but *respondeat superior*'s general superiority in performing that task, discussed above, is a large part of its claim for efficiency. However, detailed arguments have been made that this efficiency cannot be presumed in all circumstances.<sup>299</sup> Sykes has argued that *respondeat superior*'s strict liability is likely to be efficient if two conditions are present: (a) the tort is causally related to the principal's business, and (b) imposition of liability does not lessen the employee's incentive to avoid tortious conduct.<sup>300</sup> Both conditions are present in the section 10(b) and Rule

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Seavy, *Speculations as to "Respondeat Superior,"* HARVARD LEGAL ESSAYS 433 (1934), "that respondeat superior but not a negligence standard can generate the optimal level of employee tort prevention is well-motivated").

<sup>296</sup> See Croley, *supra* note 283, at 1730 n.85 (dipping into psychology literature to show that individuals are frequently irrational and therefore cannot easily be induced to take optimal due care measures, and arguing further that placing liability upon agents will be ineffective where (a) the agents are judgment-proof, (b) the agents demand liability insurance, creating moral hazard problems, and (c) firms and not individuals bear the costs of care because individuals may be excessively careful (citing Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1681 (1996))).

<sup>297</sup> See Chapman, *supra* note 296, at 1681.

<sup>298</sup> Arlen & Carney, *supra* note 271, at 705-06 (emphasis added).

<sup>299</sup> See generally Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984) [hereinafter Sykes, *Economics*]; Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168, 196-97 (1981) (noting that the key factors in determining whether *respondeat superior* will be efficient include "the existence of an opportunity for conscious allocation of tort risks between the principal and the agent, the effects of financial incentives on precautionary behavior, and the ability of the principal to monitor the precautionary behavior of the agent").

<sup>300</sup> See Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of*

*the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 581–88 (1988) [hereinafter Sykes, *Boundaries*].

Arlen argues that, in the criminal context, another concern is that strict vicarious liability for firms actually lessens the firm's incentive to police illegal acts and therefore can lead to more illegal acts being committed. See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 833–67 (1994). She reasons that crimes are often better detected by the corporation than by the government and that strict liability gives the corporation the incentive to spend less on detecting and investigating crimes so as to minimize its liability by minimizing its own detection of its agents' crimes. Arlen's arguments are interesting, but not ultimately persuasive in the current context.

First, Arlen focuses only on vicarious liability's incentives to detect and report wrongdoing. *Id.* at 836. She completely ignores the incentive to prevent wrongdoing that vicarious liability provides to the firm, except to say that this might not be the most efficient use of its resources. *Id.* at 861.

Second, one of Arlen's basic assumptions—that the wrongdoing is difficult for any entity other than the company to detect—is dead wrong in the securities field, at least according to Arlen herself. She pointed this out in her earlier article with Carney. See Arlen & Carney, *supra* note 271, at 701 (“[S]ecurities fraud is a tort (and a crime) that is peculiarly susceptible to ultimate detection when committed by agents of publicly held corporations.”).

Third, another of Arlen's basic assumptions—that crimes are committed primarily by employees of closely held corporations—does not apply to the most important category of securities fraud cases, the fraud on the market cases that Arlen discussed in her article with Carney. *Id.* at 841 n.31. This distinction is important because Arlen is using pure economic reasoning to conclude that a corporation will not spend money to detect wrongdoing because that will cost the corporation more in fines, but the money for the fines comes out of the shareholders' pockets, primarily. The decision to detect and prevent made in public corporations is made by employees. These employees will often know about the fraud because of their position in the firm. They will have incentive to prevent and detect fraud because of their own innate honesty (usually ignored by economists) and because of their self-serving desire to be associated with a company with a reputation for honesty that will not suffer the often-devastating reputational and economic losses that often are the consequence of fraudulent schemes. If the employees do know about the fraud, they (unlike the shareholders) have every personal incentive to report it, as Arlen herself admits. See *id.* at 858 (“[P]owerful incentives exist for innocent corporate managers who discover evidence of crime to report them.”).

Fourth, Arlen arguably underestimates the incentive to enforce that is built into various mitigation provisions in the law that functionally reward firms for policing their own. See, e.g., *United States v. Basic Constr. Co.*, 711 F.2d 570, 573 (4th Cir. 1983) (holding that a jury may consider corporate compliance programs in deciding whether a corporation is liable for its agents' crimes); *United States v. Beusch*, 596 F.2d 871, 877–78 (9th Cir. 1979) (same). See generally Dan K. Webb et al., *Understanding and Avoiding Corporate Executive Criminal Liability*, 49 BUS. LAW. 617, 619 (1994) (explaining how effective corporate compliance program can minimize a firm's liability in criminal cases under the Organizational Federal Sentencing Guidelines).

Fifth, Arlen herself seems to limit her analysis to the criminal setting, distinguishing it



10b-5 context. The causal relationship is established by the requirement that for *respondeat superior* liability to apply, the agent must be acting either within the scope of actual authority or within apparent authority supplied by the principal. Furthermore, imposition of liability upon the principal does not lessen the employee's incentive to avoid tortious conduct. The employee who commits securities fraud in violation of section 10(b) and Rule 10b-5 continues to face, in addition to employment penalties imposed by the employer,<sup>301</sup> at least the following: (a) joint and several liability to injured plaintiffs,<sup>302</sup> (b) a potential indemnity or contribution action by the principal,<sup>303</sup> (c) civil liability including

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from civil tort law. See Arlen, *supra*, at 842. Section 10(b) and Rule 10b-5, of course, carries both civil and criminal liability.

<sup>301</sup> These penalties can include ostracism, "passing over" at promotion or raise time, and dismissal. Stone, *supra* note 273, at 29.

Sykes believes that these employment penalties, standing alone or coupled with indemnity actions, do not always sufficiently encourage employees to avoid committing torts. See Sykes, *Boundaries*, *supra* note 300, at 570. However, Sykes was not considering a situation such as securities fraud under section 10(b) and Rule 10-5, which carries a whole host of other incentives for employees to do the right thing.

<sup>302</sup> Although Arlen and Carney argue against vicarious liability in fraud on the market cases and stress that plaintiffs almost always sue the firm and seldom sue only the agents and not the firm, their own numbers show that in the vast majority of cases plaintiffs sue both the firm and the wrongdoing agents. See Arlen & Carney, *supra* note 271, at 739 (Table 6).

Of course, the agents, if they are high-level corporate officers, usually have liability insurance. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 550 (1991) (noting that 94% of public companies have directors and officers liability insurance). However, such policies typically have exclusions for wrongs based on dishonest behavior such as securities fraud. See Dale A. Oesterle, *Limits on a Corporation's Protection of Its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513, 549-50.

<sup>303</sup> Admittedly, studies show that employers generally do not avail themselves of the right to collect indemnity from their employees. See Fleming James, Jr., *Vicarious Liability*, 28 TUL. L. REV. 161, 162 (1954); Fleming James, Jr., *Accident Liability Reconsidered: The Impact of Liability Insurance*, 57 YALE L.J. 549, 556-57 (1948). In part this decision may be reflective of a broad trend in the law to expand the range of situations in which agents can be indemnified by their employers and to narrow the range of circumstances under which employers can be indemnified by their employees. See Stone, *supra* note 273, at 46. Schwartz, however, offers four common-sense reasons arising from the nature of the employment relationship. See Schwartz, *supra* note 3, at 1764-67. In addition, both the courts, see *Globus v. Law Research Serv.*, 418 F.2d 1276, 1287-89 (2d Cir. 1969) and the SEC, see Regulation S-K, Items 702, 510, and 512, 17 CFR § 229 (1996), are generally hostile to complete indemnification in such cases.

Of course, the mere fact that few such actions are filed does not mean that the potential for their filing does not have a deterrent effect. One recent study shows that although only about 2% of all directors are sued, 70% of those surveyed seriously considered the potential

huge fines in an SEC action,<sup>304</sup> (d) potential jail time and additional large fines in a criminal action,<sup>305</sup> (e) loss of the opportunity to practice one's profession,<sup>306</sup> and (f) the stigma of being the subject of civil or criminal action.<sup>307</sup> So, to repeat, the choice is not individual liability of the agent versus

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for liability in deciding whether to serve as directors (and presumably in deciding how seriously to take their responsibilities as directors). See Mary Colby, *The Risky Business of Finding Community Bank Directors*, BANK MGMT., Jan. 1993, at 14 (citing Huggins & Assoc. survey).

Furthermore, the right to contribution was clearly established in *Musick, Peeler, & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294-98 (1993). That right has been statutorily confirmed by the PSLRA.

<sup>304</sup> See 15 U.S.C. § 78u(d) (Supp. I 1997) (providing for civil fines of up to \$100,000 for a natural person and \$500,000 for any other person, per violation).

<sup>305</sup> See 15 U.S.C. § 78ff (Supp. I 1997) (section 32 provides for penalties of up to ten years in jail and a \$1,000,000 fine for natural persons and fines of up to \$2,500,000 for other persons for intentional violations of any provision of the 1934 Act).

In addition to the penalties included in the securities statutes, most securities fraud violations are simultaneous mail and wire fraud violations that carry additional criminal penalties. In one recent case, a violator of section 10(b), Rule 10b-5, and other provisions was sentenced to twenty years in jail; ordered to make restitution of \$462,556,436; ordered to pay a fine of \$1,000,000; and ordered to pay a special assessment of \$250. See *United States v. Hoffenberg*, 1997 WL 96563, Nos. 94 Cr. 213 (RWS) and 95 Cr. 321 (RWS) (S.D.N.Y., Mar. 5, 1997).

<sup>306</sup> Being subject to administrative or injunctive orders for securities fraud may also result in the defendant being barred from serving as an investment advisor. See 15 U.S.C. § 80b-3(e) (Supp. I 1997).

Also, under Rule 102(e) [formerly known as Rule 2(e)], the SEC can and often does bar lawyers and accountants who have violated SEC Rules from practicing before the Commission. See 15 C.F.R. § 201.102(e) (1996). See generally Marie L. Coppolino, Checkosky, *Rule 2(e) and the Auditor: How Should the Securities and Exchange Commission Define Its Standard of Improper Professional Conduct?*, 63 FORDHAM L. REV. 2227, 2227-63 (1995) (criticizing SEC's active use of Rule 2(e) to punish auditors); Christine Neylon O'Brien, *SEC Regulation of the Accounting Profession*, 21 GONZ. L. REV. 675, 675-90 (1985-1986) (summarizing grounds upon which accountants have been punished under Rule 2(e)).

Furthermore, under powers granted to the SEC by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. at 933, the SEC can seek from a federal court an order barring egregious wrongdoers from ever again serving as officers or directors in public companies. 15 U.S.C. § 78u(d)(2) (Supp. I 1997). The SEC has used this power. See, e.g., Wade Lambert, *Posner, Son Barred From High Positions At Public Companies*, WALL ST. J., Dec. 2, 1993, at A3 (reporting on case involving infamous Posner family).

<sup>307</sup> Arlen and Carney suggest that "agents are stigmatized more by civil judgments than they are by sanctions imposed privately by firms." Arlen & Carney, *supra* note 271, at 709

vicarious liability of the firm, as is often assumed. Rather, the choice is individual liability of the agent versus a combination of individual liability of the agent and *respondeat superior* liability of the firm. There is every reason to believe that the latter regime is both more of a deterrent to fraud and more efficient than the former.

Looking at the issue from another angle, Kramer and Sykes have argued that if an employee is judgment-proof (and few individual employees will have the funds to pay the often huge damages caused by large-scale securities fraud),<sup>308</sup> then a system based solely on personal liability of the employee is clearly inefficient in that it allows a firm to "externalize" costs of doing business by passing off all or part of the losses to the victim, leading to the following inefficiencies: (a) inadequate incentive to avoid the occurrence of torts, (b) inefficient allocation of risk, and (c) distortion in the scale of activity.<sup>309</sup>

Strict liability regimes have been criticized generally because they minimize the incentives of potential plaintiffs to protect themselves from harm to the

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(citing John R. Lott, Jr., *An Attempt At Measuring the Total Monetary Penalty From Drug Convictions: The Importance of an Individual's Reputation*, 21 J. LEGAL STUD. 159, 184-85 (1992) (suggesting that white collar criminals face higher collateral penalties—lost wages, etc.—than blue collar counterparts)).

<sup>308</sup> In the situation where an agent can pay all judgments against him, many believe that a rule of pure personal liability of the agent is as efficient as a rule of joint and several liability of agent and principal under *respondeat superior*. See Kornhauser, *supra* note 276, at 1358-60; Sykes, *Economics*, *supra* note 299, at 1241.

<sup>309</sup> See Kramer & Sykes, *supra* note 109, at 277-78; see also Sykes, *Boundaries*, *supra* note 300, at 1246.

Long ago Calabresi spoke of the need to force firms to internalize their costs in order to maximize efficient resource allocation:

Equally strong allocation-of-resources arguments can be made . . . [T]he failure to show injury costs means that the prices of the goods the industry sells understate their true costs, and that too much is produced in that industry compared to those which are less accident prone . . . [R]espondeat superior would tend toward a better allocation of resources.

Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 544 (1960).

Kramer and Sykes also demonstrate that the first two of these inefficiencies also result when the employer is a municipality, see Kramer & Sykes, *supra* note 109, at 278-83; hence, they suggest that a more efficient system would result from replacing *Monell's* "policy" rule with a standard *respondeat superior* regime, or, even better in their eyes, a negligence approach to municipal liability for egregious torts committed in bad faith by underlings. *Id.* at 301.

extent that they eliminate contributory or comparative negligence defenses.<sup>310</sup> This minimization may be a legitimate concern in the products liability area. However, in the section 10(b) and Rule 10b-5 context, plaintiffs often have no realistic opportunity to protect themselves from securities fraud,<sup>311</sup> and, if they do have such an opportunity and fail to do so, they may be denied recovery by the due diligence defense.<sup>312</sup>

## ii. *Legitimate Expectations of Business*

Elimination of *respondeat superior* liability would likely cause, rather than avoid, inefficiencies. The intertwining world of public corporations and the securities industry is extremely complex. Corporate and other artificial entities must and do carry out their activities through agents. For business to be conducted in an efficient manner, investors dealing with agents must be able to hold principals accountable for agents' securities law violations just as they can hold them responsible for any other legal infractions by agents.<sup>313</sup>

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<sup>310</sup> See Verkerke, *supra* note 94, at 324.

<sup>311</sup> See *supra* note 294 and accompanying text.

<sup>312</sup> See, e.g., Schlesinger v. Herzog, 2 F.3d 135, 141 (5th Cir. 1993); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1515-19 (10th Cir. 1983); White v. Sanders, 689 F.2d 1366, 1369 (11th Cir. 1982) (per curiam); Mallis v. Bankers Trust Co., 615 F.2d 68, 78-79 (2d Cir. 1980); Holmes v. Bateson, 583 F.2d 542, 559 (1st Cir. 1978); Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir. 1977); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir. 1977); McDaniel v. Compania Minera Mar de Cortes, 528 F. Supp. 152, 166-67 (D. Ariz. 1981); National Bank v. Whitehead & Kales Co., 528 F. Supp. 940, 949 (E.D. Mich. 1981). See generally Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985) (criticizing use of the doctrine to bar recovery); William H. Mohr, *Caveat Emptor Resurfaces In Securities Rulings*, N.Y. L.J., Nov. 4, 1993, at 5 (analyzing recent application of the doctrine).

To some extent, at least, this due diligence defense has morphed into the "bespeaks caution doctrine" defense that has been widely and successfully used by defendants. See generally Royce de R. Barondes, *The Bespeaks Caution Doctrine: Revisiting the Application of Federal Securities Laws to Opinions and Estimates*, 13 IOWA J. CORP. L. 244 (1994) (summarizing applications of the doctrine); Dennis J. Block et al., *Court Defines Scope of Bespeaks Caution Doctrine*, N.Y. L.J., Nov. 18, 1993, at 5 (same). This doctrine has been partially codified in the PSLRA.

<sup>313</sup> See William H. Kuehnle, *Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313, 367 (1988) [hereinafter Kuehnle, *Secondary*]; Vincent P. Liberti, *Joint and Several Liability Under Rule 10B-5: The Apportionment of Liability for Contribution Claims Involving Non-Settling Defendants*, 7 DEPAUL BUS. L.J. 45, 57 (1994); Bart McKay, Note, *Inherent Agency Powers: Does Celtic Life Insurance Co. v.*

This is only fair, but more importantly, it encourages investors to “play the game,” to invest, and to engage in securities transactions. Firms in the brokerage industry, where the greatest complaints against *respondeat superior* liability arise, constantly advertise in order to establish and bolster the reputation of their firm for honesty and reliability.<sup>314</sup> The typical investor relies on the reputation of the firm with which he deals more than the reputation of the particular employee,<sup>315</sup> as the SEC has explained:

Many, probably a majority, of the frauds practiced by securities firms involves conduct by employees—typically sales representatives who make false or unfounded representations with respect to securities. It is the Commission’s experience that from time to time salesmen actually whet the appetites of gullible public customers by representing that they are breaking their employers’ rules by giving them a special deal; for example, by giving them more than the prescribed quota of a new issue of securities. But, whatever the representations made by the salesmen or other employees of the broker-dealer, we have found that investors customarily rely primarily on the integrity, reputation, and responsibility of the firm itself rather than on the character of the particular employee with whom they happen to be dealing. It is the firm that is accepting and retaining the profits from the transactions. . . and it is the firm to whom the customer should be permitted and expected to look if his trust has been abused.<sup>316</sup>

The same holds true for accounting firms, especially the Big Six firms, which also trade on their reputation for reliability:

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Coats *Open the Door to a New Theory of Vicarious Liability in Texas?*, 46 BAYLOR L. REV. 449, 451 (1994) (explaining that part of the rationale for Restatement (Second) of Agency section 257’s provision for apparent authority liability is that “[t]he commercial world must be able to rely to a great extent on the appearance of things, without having to constantly check on whether an agent is deviating from his authority”).

<sup>314</sup> See, for example, “E.F. Hutton makes money the old-fashioned way; they earn it.”

<sup>315</sup> See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir. 1980) (investors rely on reputation of firm, not individual employee); *Holloway v. Howerdd*, 536 F.2d 690, 696 (6th Cir. 1976) (same); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1313 (E.D. Va. 1981) (same); see also Note, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 719 (1974) (“The average investor, however, is entitled to, and customarily does, rely on the integrity, reputation, and responsibility of the brokerage firm itself, rather than the particular employee with whom he deals.”).

<sup>316</sup> SEC Brief in *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F.2d 689 (9th Cir. 1967), at 23 [hereinafter *Kamen Brief*] (quoted in David S. Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 607 n.41 (1972)).

The mere fact that a firm doing an initial public offering (IPO) has a Big Six firm as its auditor provides credibility, attracts more investors, and allows the issuer to charge more for its shares than it otherwise could. The Big Six firm is paid for its work but receives a premium for its reputation as well. In part, this is true because information asymmetries make it very difficult for shareholders and auditors to assess the accuracy of any given audit, so the auditor's reputation must serve as a proxy for the quality of any given audit.<sup>317</sup>

The same "reputation renting" phenomenon occurs regarding auditors' work in the secondary markets and the work of underwriting firms, investment banks, and law firms.<sup>318</sup> In all these situations, investors rely upon the reputation of the law firm, the accounting firm, and the underwriting firm, rather than that of the individual lawyers, accountants, and underwriter employees. If these firms are not liable for fraudulent statements, then their reputations mean nothing; their statements are largely empty; and their role as information verifiers in a complex economy is badly damaged. Such a development would ill serve the cause of efficiency. It would require investors to verify for themselves information that is more easily and inexpensively verified by these firms,<sup>319</sup> or to do less investing because, it has been posited, "investors cannot, even by diligence, protect themselves against [the risk of securities fraud] except by doing less investing."<sup>320</sup> This statement may overstate the case slightly, but probably not too much given the difficulty of discovering securities fraud committed by a clever perpetrator. Simply being more vigilant will seldom protect an investor from any but the most blatant fraudulent schemes. Even if detection of such fraud by investors is possible, too little compensation under the securities laws will lead, at best, to an inefficiently high level of private investigation by investors who cannot rely upon the companies and accounting firms that produce audited financial statements.<sup>321</sup>

### iii. *Respondeat Superior Enables Our Legal System to Spread Costs*

Another efficient aspect of *respondeat superior* liability is that it allows for the spreading of the risk of loss.<sup>322</sup> The Supreme Court has recognized cost-

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<sup>317</sup> Prentice, *supra* note 17, at 740 (footnotes omitted).

<sup>318</sup> *Id.* at 740-46.

<sup>319</sup> See generally Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 290 (1984) (discussing how reputational intermediaries reduce information costs); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 621 n.197 (1984) (same).

<sup>320</sup> Conard, *Enterprise Liability*, *supra* note 179, at 954 (discussing ITSFEA).

<sup>321</sup> See Easterbrook & Fischel, *supra* note 288, at 620.

<sup>322</sup> See Pitt & Groskaufmanis, *supra* note 282, at 1563 ("Loss distribution is the most

spreading as a major justification for *respondeat superior*.<sup>323</sup> If both an employee and his firm err, it certainly is fair to impose the loss on the firm, which can then shift the loss at least to its customers and more likely to its insurance company, which can spread the loss around the economy.<sup>324</sup> If the firm is not at fault, then the question becomes which of two innocent parties (the victim of the fraud or the firm) should bear the loss. To place the entire loss on the innocent victim, who cannot spread it, is obviously unfair. To place the loss instead upon the good faith firm that often could have prevented the loss by more carefully choosing and supervising its employees and, failing that can still spread the loss, is clearly the better system. Furthermore, the deep pocket defendant's superior ability to spread losses similarly reduces the likelihood that adverse secondary economic effects will arise from the loss.<sup>325</sup>

The risk-spreading facets of *respondeat superior* liability have in recent years been viewed as less important than they once were in the areas of the greatest tort litigation—automobile accidents and products liability—because drivers, passengers, and consumers of products can buy medical insurance.<sup>326</sup> This trend, for example, has led to calls for no-fault insurance plans.<sup>327</sup> However, investors cannot as effectively insure themselves against loss caused by securities fraud;<sup>328</sup> therefore, the loss distribution features of a *respondeat superior* system remain desirable in the securities industry.<sup>329</sup>

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widely accepted justification for the doctrine of *respondeat superior*.”); Smith, *supra* note 214, at 456 (noting “the belief that it is socially more expedient to spread or distribute among a large group of the community the losses which experience has taught are inevitable in the carrying on of industry, than to cast the loss upon a few”); *see also* Horn v. Duke Homes, 755 F.2d 599, 605 (7th Cir. 1985) (explaining that employer should bear the cost of sexual harassment by supervisor because it is a more efficient risk bearer than the victim).

<sup>323</sup> See *Monell v. New York City Dep't of Social Servs.*, 436 U.S. 658, 693–94 (1978).

<sup>324</sup> See Calabresi, *supra* note 309, at 543 (“The master is the best insurer, both in the sense of being able to obtain insurance at the lower rates and in the sense of being most aware of the risk. Consequently, he is the best primary risk spreader.”).

<sup>325</sup> See *id.* at 527.

<sup>326</sup> See Richard A. Epstein, *Products Liability as an Insurance Market*, 14 J. LEGAL STUD. 645, 645–69 (1985).

<sup>327</sup> See, e.g., PETER W. HUBER, *LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES* 193–206 (1988) (arguing for increased use of direct insurance and reduced use of tort law); STEPHEN D. SUGARMAN, *DOING AWAY WITH PERSONAL INJURY LAW: NEW COMPENSATION MECHANISMS FOR VICTIMS, CONSUMERS, AND BUSINESS* 127–48 (1989) (advocating replacement of tort liability with social insurance and regulatory system). See generally George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1553–60 (1987) (noting that the administrative costs of a strict liability regime will usually exceed those of first-party insurance).

<sup>328</sup> They may, of course, minimize their risk of loss by diversifying their portfolios.

<sup>329</sup> See Conard, *Enterprise Liability*, *supra* note 179, at 948–49 (“[E]mployers in the

In short, the same policy considerations that have led to the almost universal adoption of *respondeat superior* throughout Western jurisprudence also weigh heavily in favor of its application in section 10(b) and Rule 10b-5 cases, as even some of its harshest opponents admit.<sup>330</sup> Those policies are the same today as they were in 1934, five years after the Supreme Court had recognized that *respondeat superior* was a basic feature of federal law, at bottom, because of “accepted notions of social policy.”<sup>331</sup>

### III. *RESPONDEAT SUPERIOR* AND SECTION 20(A)

Much of the analysis of Part II is directly relevant to the basic issue discussed now in Part III: Should section 20(a)’s controlling person provision be recognized as the exclusive means of imposing secondary liability for securities fraud under the 1934 Act? Therefore, not only will the method of analysis suggested by *Central Bank* be applied here just as it was in Part II, but many of the specific arguments will be much the same as well. In essence, Part III’s discussion revisits the long-standing debate regarding the exclusivity of section 20(a) to determine whether the majority of courts was correct in rejecting exclusivity and whether anything in *Central Bank* should change those courts’ minds. The answers to those two inquiries are, respectively, “yes” and “no.”

#### A. *Statutory Language*

Proponents of exclusivity argue that because the good faith defense of section 20(a) is expressly made available to all controlling persons and the 1934 Act contains no express provision for *respondeat superior* liability, “the language of the statute appears to preclude” the latter form of liability.<sup>332</sup> This view ignores all the arguments made in Part II(B) of this Article; those arguments indicate that the language of the 1934 Act does indeed strongly indicate that *respondeat superior* liability is to be available. Why else would Congress have defined “person” to include a “company” that can only act through agents? What other meaning is it possible to give to the “directly or

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securities industry are likely to have the necessary resources to compensate losses and a continuity of activities that enables them to spread the costs across a large number of transactions.”).

<sup>330</sup> Fitzpatrick and Carman strongly oppose the availability of *respondeat superior* liability on grounds of text and legislative history, but admit “[t]aken alone, policy considerations might suggest that the [*respondeat superior*] doctrine should be applied in civil fraud actions brought under the federal securities laws.” Fitzpatrick & Carman, *supra* note 7, at 28.

<sup>331</sup> See *Gleason v. Seaboard Airline Ry.*, 278 U.S. 349, 355–56 (1929).

<sup>332</sup> See, e.g., York, *supra* note 7, at 354.



indirectly” language of the statute?

Focusing just on the issue of exclusivity, other evidence arises. First and foremost, nowhere in the language of section 20(a) does Congress ever state that its provisions for controller liability are to be the sole means of imposing secondary liability. When sitting on the First Circuit, Justice Breyer noted in this connection that “section 20(a) does not say that it is exclusive; and its proviso (‘unless’) is naturally read as referring to the (potentially *nonexclusive*) liability which section 20(a) *itself* provides.”<sup>333</sup> The language of section 10(b) does not include “*respondeat superior*,” but neither does that of section 20(a) include “exclusive.”

Congress knows how to create a private cause of action when it wants to do so,<sup>334</sup> so it presumably also knows how to make a liability provision exclusive if it wishes. Given that *respondeat superior* was the established rule at the time Congress enacted section 20(a), a fact that Congress well knew,<sup>335</sup> one would expect that if Congress had any desire to eliminate such liability it would have said so in the statute.<sup>336</sup>

A potential rejoinder is that the *Central Bank* majority also pointed out that Congress knew how to impose aiding and abetting liability when it wanted to do so,<sup>337</sup> citing various non-securities statutory provisions.<sup>338</sup> Perhaps this means that Congress did not wish to impose *respondeat superior* liability because it was not expressly mentioned either. However, two obvious answers to this argument that have already been lodged are that Congress did indeed provide for *respondeat superior* liability both by use of the “or indirectly” language<sup>339</sup>

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<sup>333</sup> *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986).

<sup>334</sup> See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734 (1975) (“When Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so.”); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 21 (1979) (stating that when Congress wishes to create a private cause of action, it knows how to do so).

<sup>335</sup> See *supra* note 2 and accompanying text.

<sup>336</sup> See *Musewicz*, *supra* note 7, at 780 (“Congress’s failure to forbid applying common-law concepts to section 10(b), though it acted in a legal context in which the general application of such concepts to federal statutory violations was known, is additional evidence that Congress intended their application to section 10(b) violations.”).

<sup>337</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 179 (1994).

<sup>338</sup> See, e.g., *Packers and Stockyards Act*, ch. 4, sec. 202, 42 Stat. 161 (1921) (as amended at 7 U.S.C. § 192(g) (1980)).

<sup>339</sup> If section 20(a) is the sole means of imposing secondary liability under the 1934 Act, then the “or indirectly” language of section 10(b) is rendered superfluous. To assume that Congress used these words but accorded them no meaning, when a perfectly logical meaning—that it was a mechanism for recognizing the viability of *respondeat superior*

in section 10(b) and by its definition of "person" in section 3(a)(9),<sup>340</sup> and that almost nowhere in the United States Code does Congress provide expressly for *respondeat superior* liability because it need not do so. Such liability is well-established and universal in application even without express Congressional references. It is nearly universal in federal law despite seldom being expressly provided for statutorily.

Admittedly, the issue is not free from doubt. For example, section 15 of the 1933 Act specifically includes agency relationships as examples of "control" relationships.<sup>341</sup> Therefore, it can be asserted that section 15 was Congress's explicit provision for all liability to arise from agency relationships. A counter argument could be that Congress's omission of the "agency" term from section 20(a) indicates that it meant to exclude such relationships from the scope of this 1934 Act provision. However, the House Report on section 20(a) also names agency as an example of control.<sup>342</sup>

Nonetheless, most courts have agreed that these references alone are insufficient to overcome all the other evidence that Congress intended to retain agency liability in addition to controlling person liability.<sup>343</sup> It is unlikely, given the complete lack of other evidence to support the conclusion, that section 15's use of the term "agency" was meant to deliberately exclude *respondeat superior* liability.<sup>344</sup> Nor does the "inconspicuous embedding of the word

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liability—is available, is not sound statutory construction.

<sup>340</sup> See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975) ("Were §§ 15 and 20(a) the sole measures of corporate liability, . . . the inclusion of corporations under the definitions of 'person' would be not only unnecessary but also misleading.").

<sup>341</sup> The strongest textual argument for exclusivity comes from the very words of section 15, which applies to "[e]very person who, by or through stock ownership, *agency* or otherwise controls any person liable under sections [11] or [12]." 15 U.S.C. § 77o (1981) (emphasis added).

<sup>342</sup> See H.R. Rep. No. 1383, at 26 (1934):

In this section . . . when reference is made to "control," the term is intended to include actual control as well as what has been called legally enforceable control . . . It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and *agency*.

(emphasis added).

<sup>343</sup> See *Seiter*, *supra* note 7, at 1515 n.18 ("Though the term 'control' in section 20(a) is broad enough to comprehend employment relations, it does not appear that Congress designed the section with employers in mind.").

<sup>344</sup> See *id.* at 1526 ("It is improbable that Congress intended the bare term 'agency' as an allusion to the doctrine of respondeat superior, which applies not to all principal-agent relations but only to employer-employee relations under limited circumstances.").

‘agency’ in the House Report on section 20(a) carry much weight.”<sup>345</sup>

Section 20(a) itself requires recognition of *respondeat superior* liability any time it is applied to organizational defendants, as it often has been.<sup>346</sup> A corporation or other artificial legal entity cannot in any real sense “control” its employees. To speak of a corporation “controlling” its executives creates a definite circularity problem when, as a matter of physical reality, executives control the corporation.<sup>347</sup> To the extent that Congress wished to have corporations held liable as “controlling ‘persons,’” remembering that “person” is defined to include companies, Congress necessarily must have desired that those corporations be held liable for the controlling acts of their executives and directors, which can only be done by invoking agency principles such as *respondeat superior*.<sup>348</sup> Exclusivity is, therefore, impossible by section 20(a)’s own terms.

Finally, a Congressional intent that section 20(a) be the sole mechanism for imposing secondary liability would have been dispositive of the aiding and abetting issue in *Central Bank*. Therefore, one would suppose that the Supreme Court would have mentioned that fact in *Central Bank*. It did not.

### B. Analogous Statutory Provisions

As noted in Part II(C) above, in *Musick, Peeler*, the Supreme Court stated that one of its goals was to ensure that its interpretation of the elements of liability under section 10(b) and Rule 10b-5 did not conflict with Congress’s

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<sup>345</sup> See *id.*

<sup>346</sup> See, e.g., *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 883 (7th Cir. 1992) (imposing controlling person liability on a brokerage firm); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1567 (9th Cir. 1990) (en banc) (brokerage firm); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 181 (3d Cir. 1981) (accounting firm); *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971) (insurance company).

In terms of consistency of statutory scheme, consider this scenario: Corporation A, which is actively managed and owned 90% by Corporation B, issues fraudulent financial statements. If section 20(a)’s controlling person provision provides the sole form of secondary liability under section 10(b) and Rule 10b-5, then Corporation A cannot be liable for the false financial statements that its officers issued because *respondeat superior* is not available. However, Corporation B is arguably liable as a controlling person of Corporation A even though Corporation B, like Corporation A, can act only through human beings who are its officers, directors, and other agents. The anomaly is obvious.

<sup>347</sup> Burns, *supra* note 294, at 1195.

<sup>348</sup> See *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 34 (1st Cir. 1986) (“[S]ince corporations can act only through agents, how, without principles of vicarious liability, . . . could this ordinarily be done?”).

own express causes of action.<sup>349</sup> The discussion in Part II(C) demonstrated that inclusion of *respondeat superior* in the implied section 10(b) cause of action does not conflict with section 9 or section 18 of the 1934 Act. Therefore, imposition of *respondeat superior* liability under section 10(b) and Rule 10b-5 creates such a conflict only if section 20(a) is the sole mechanism by which Congress intended to impose secondary liability under the 1934 Act. As just noted, the language of the statute does not support section 20(a)'s exclusivity. Neither does the structure of the Act.

### 1. Section 15

Because section 20(a) is patterned after section 15,<sup>350</sup> if the latter is not the exclusive means of imposing secondary liability under the 1933 Act, then to preserve structural consistency, the former should not be the exclusive means of imposing secondary liability under the 1934 Act. And, indeed, the entire structure of the 1933 Act seems to presume application of agency principles.

First, section 11 imposes liability upon the issuer, which is usually an entity that can be liable only upon agency principles.<sup>351</sup> Second, section 11 also imposes liability upon various "persons," which the 1933 Act defines to include corporations, partnerships, associations, joint-stock companies, trusts, and other artificial entities that can act only through agents and therefore can be held liable only on a *respondeat superior* basis.<sup>352</sup> Third, section 11 accords defendants other than the issuer a "due diligence" defense.<sup>353</sup> A corporate underwriter or an accounting firm could meet this requirement only through its employees, requiring application of agency rules.<sup>354</sup> Fourth, section 12 imposes liability upon any "person" (already defined to include artificial entities) who is a "seller" of securities that has violated section 5<sup>355</sup> or that has made misrepresentations.<sup>356</sup> The "seller" includes anyone who transfers title,<sup>357</sup>

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<sup>349</sup> See *Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 295 (1993). Other goals were to promote clarity, consistency, and coherence for those who rely upon or are subject to Rule 10b-5 and to effect Congress's objectives in enacting the securities laws. *Id.*

<sup>350</sup> See *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986) ("Section 20(a) was modeled on section 15 of the 1933 Securities Act . . . and it has an identical purpose.").

<sup>351</sup> See 15 U.S.C. § 77k (1981).

<sup>352</sup> See 15 U.S.C. § 77b(2) (1981).

<sup>353</sup> See 15 U.S.C. § 77k(b) (1981).

<sup>354</sup> See *Burns*, *supra* note 294, at 1213.

<sup>355</sup> Such a violation is actionable under section 12(a)(1). See 15 U.S.C. § 77l(a)(1) (Supp. I 1995).

<sup>356</sup> Such a misrepresentation is actionable under section 12(a)(2). See 15

which will often be an artificial entity such as the issuing company, an underwriter, or a broker-dealer.

Artificial entities have traditionally and uncontroversially been held liable, necessarily on agency grounds, under both section 11<sup>358</sup> and section 12<sup>359</sup> of the 1933 Act.

## 2. Section 28(a)

Congress enacted section 10(b) and other securities provisions against a backdrop of state common law that included *respondeat superior* liability. Because enactment of the 1934 Act also predated the *Erie* doctrine,<sup>360</sup> a body of federal common law that clearly included *respondeat superior* liability also existed.<sup>361</sup> It is therefore arguable that Congress did not enact section 10(b) with the intent of replacing state and federal common law remedies and doctrines because section 28(a) of the 1934 Act explicitly provides that “[t]he rights and remedies provided by this [title] shall be in addition to any and all other rights and remedies that may exist at law or in equity.”<sup>362</sup> It may further be argued that it is the attempt to eliminate *respondeat superior* liability in clear contravention of section 28(a)’s explicit wording that upsets the statutory scheme.<sup>363</sup> Section 28(a) of the 1934 Act and the analogous savings clause in the 1933 Act, it has been argued, “are eloquent testimony to the absence of any intent to preempt common law secondary liability.”<sup>364</sup> Indeed, the Supreme Court has stated that section 28(a) and a parallel savings provision in the 1933

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U.S.C. § 771(a)(2) (Supp. I 1995).

<sup>357</sup> See, e.g., *Pinter v. Dahl*, 486 U.S. 622, 642–47 (1988) (“seller” may also include “persons” in addition to those who actually transfer title).

<sup>358</sup> See, e.g., *Escott v. BarChris Construction Co.*, 283 F. Supp. 643, 643–707 (S.D.N.Y. 1968) (imposing liability upon an issuing corporation, an underwriting firm, and an accounting firm).

<sup>359</sup> See, e.g., *Holloway v. Howerdd*, 536 F.2d 690, 690–95 (6th Cir. 1976) (brokerage firm); *Fey v. Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974) (same); *Lewis v. Walston & Co.*, 487 F.2d 617, 623–24 (5th Cir. 1973) (same).

<sup>360</sup> *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938) (restricting use of federal common law).

<sup>361</sup> See *supra* notes 219–21.

<sup>362</sup> 15 U.S.C. § 78bb(a) (1981). Several lower courts have read section 28(a) as providing evidence that Congress did not intend section 20(a)’s controller liability provision to exclude *respondeat superior* liability. See, e.g., *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980).

<sup>363</sup> See *Commerford v. Olson*, 794 F.2d 1319, 1323 (8th Cir. 1986); *Marbury Management*, 629 F.2d at 716.

<sup>364</sup> IX LOSS & SELIGMAN, *supra* note 201, at 4477.

Act<sup>365</sup> “confirm that the remedies in each Act were to be supplemented by ‘any and all’ additional remedies.”<sup>366</sup>

Although a strong argument can thus be made that section 28(a) preserves state and federal common law remedies, including *respondeat superior*, the counterargument is that section 28(a) is merely an indication that federal law does not preempt the field and that there is still room for state law causes of action:

The House Committee which drafted the bill stated that section 28 (then section 27) “reserves rights and remedies existing *outside* of those provided in the act.” Section 28 simply does not support the proposition that the common law doctrine of respondeat superior can be mixed with federally created rights to impose vicarious liability on a brokerage firm for violations of section 10(b) by its employees. This section merely preserves the state or common law remedies in existence when the federal securities laws were enacted or which were created after its enactment.<sup>367</sup>

Thus, section 28(a) serves as the basis for two arguments against exclusivity. The stronger form of the argument is that section 28(a) preserves all state law remedies such as *respondeat superior* and somehow incorporates them into the 1934 Act. The weaker form of the argument is that section 28(a) merely prevents the 1934 Act from preempting state law and thereby preserves *respondeat superior* as a state law remedy. While the more persuasive view is the weaker form of the argument, that section 28(a) was merely meant to avoid preemption of state law remedies,<sup>368</sup> its wording nonetheless gives clear evidence that Congress did not intend to contract or to merely retain the status quo regarding remedies for defrauded investors.<sup>369</sup> Rather, Congress intended

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<sup>365</sup> The savings provision of the 1933 Act is contained in section 16. *See* 15 U.S.C. § 77p (1981).

<sup>366</sup> *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983).

<sup>367</sup> *See Fitzpatrick & Carman*, *supra* note 7, at 24 (footnote omitted).

<sup>368</sup> The case for this narrower reading of section 28's purpose is strengthened by the subsequent wording of the statute that refers specifically to state securities commissioners retaining authority to enforce state blue sky laws and self-regulatory organizations such as exchanges retaining authority to punish their members. Several courts have inferred the purpose of section 28 to be the avoidance of preemption of state laws rather than the incorporation into the 1934 Act of any outside remedies. *See, e.g., Leroy v. Great W. United Corp.*, 443 U.S. 173, 182 n.13 (1979); *Mite Corp. v. Dixon*, 633 F.2d 486, 491 n.5 (7th Cir. 1980), *aff'd sub nom. Edgar v. Mite Corp.*, 457 U.S. 624 (1982). *See generally* *Musewicz*, *supra* note 7, at 790–91 nn.218–19.

<sup>369</sup> At the very least the existence of section 28(a) helps to fend off criticisms that imposing *respondeat superior* liability is some unconstitutional creation of a federal common law. *See, e.g., Duggan*, *supra* note 7, at 482–88 (making this argument). As noted earlier, the

to provide new remedies that would be more protective of investors than the state law remedies had been.<sup>370</sup> To hold that section 20(a) precludes application of *respondeat superior* liability is to provide a remedy that is less, not more, protective of investors. This is inconsistent with the overall congressional purpose and with the structure of the 1934 Act, especially (but not only) if section 28 is considered.<sup>371</sup>

### 3. The Good Faith Defense

Exclusivity proponents also argue that statutory construction should never render any part of a statute ineffectual and that such occurs if *respondeat superior*'s strict liability is allowed to nullify section 20(a)'s good faith defense.<sup>372</sup> However, no such nullification exists. As the Ninth Circuit held in *Hollinger v. Titan Capital Corp.*,<sup>373</sup> a melding of *respondeat superior* and section 20(a) controlling person liability creates a neatly-constructed statutory scheme that provides primary liability for an agent who commits a section 10(b) and Rule 10b-5 violation and secondary liability for the principal under *respondeat superior* principles when an agency relationship exists and for a "controlling person" under section 20(a) when it does not.<sup>374</sup> Strict agency liability continues to exist under all circumstances under which it would have existed pursuant to the well-established common law in place before the 1934 Act was passed, but a good faith defense exists for the nonagency situations to which section 20(a) extended secondary liability beyond where it had existed previously (using a term, "controlling persons," that had not previously existed either).<sup>375</sup> The fact that "controlling persons" are often not employers with the

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Supreme Court's decision in *Hydrolevel* is a rousing rejection of this argument as well. See *supra* notes 183–85 and accompanying text.

<sup>370</sup> See IX LOSS & SELIGMAN, *supra* note 201, at 4477 ("[T]hese [controlling person] provisions were aimed at extending liability.") (emphasis in original).

<sup>371</sup> See Note, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 719 (1974) ("The character of the harm the securities statutes were enacted to remedy indicates, however, an equal or greater likelihood that Congress, in fact, intended to increase the employer's exposure to liability.").

<sup>372</sup> See York, *supra* note 7, at 355.

<sup>373</sup> 914 F.2d 1564, 1566–79 (9th Cir. 1990) (en banc).

<sup>374</sup> See *id.* at 1577.

<sup>375</sup> The novelty of the "controlling person" provision was noted in the debates over the 1934 Act:

Mr. HOLLISTER. What would constitute such control? Can the gentleman define to me any legal way a man can decide whether he has such control? Suppose a

opportunity to exercise care in hiring the direct wrongdoers or the ability to spread the risk presents a logical policy reason for Congress to have drawn this distinction.<sup>376</sup>

### C. Congressional Intent and Legislative History

How does the legislative history of section 20(a) inform the debate about the role of *respondeat superior*? Unfortunately, reasonable minds will not agree as to what the legislative history has to say, but will probably concur that the history is not conclusive.<sup>377</sup> Nevertheless, that history provides some evidence that, like the language and structure of the 1934 Act, points away from a conclusion of exclusivity for section 20(a).

Section 15 had been enacted a year earlier without a “good faith” defense. In 1934, the 1933 Act was amended to add the good faith defense to section 15, and section 20(a) of the 1934 Act was framed to include a similar good faith

prominent stockholder names a director and then goes to Europe and the director does something illegal, would the gentleman say that the person who named the director should be held responsible?

Mr. LEA of California. It is a question of fact to be determined by the issues presented in the case. This is not a new question from a legal standpoint.

Mr. HOLLISTER. *It is a very new question from a legal standpoint.*

Mr. LEA of California. I believe it is a very well-known question in corporate law.

Mr. HOLLISTER. I wish the gentleman would refer me to any such precedent. *There is no such law in any State of the Union and no law of the United States to find out what a controlling person is, and I do not believe that the gentleman or any member of the committee can refer me to any such law. I would be pleased to have it stated if there is one.*

Mr. LEA of California. The gentleman does not doubt that one man controlling another in a corporate enterprise is a very common thing.

Mr. HOLLISTER. I know there is the test of agency, and I know of no other test which would make a person responsible criminally. *We are going far beyond any precedent in providing for criminal actions in this way.* It is part and parcel with a number of things that have been put in this bill which are absolutely contrary to all the principles of American jurisprudence.

Mr. LEA of California. It is simply a question of putting the responsibility on the man who is really responsible.

78 CONG. REC. 8095 (1934) (emphasis added).

<sup>376</sup> See Seiter, *supra* note 7, at 1535–36.

<sup>377</sup> See York, *supra* note 7, at 316 (“[S]ome analysts have concluded that the legislative history is too indefinite to be of practical interpretive value.”). Even the strongest proponents of the exclusivity of section 20(a) admit that the legislative history does not directly answer the question. See Fitzpatrick & Carman, *supra* note 7, at 22.



defense.<sup>378</sup> Despite the fact that there is precious little support for the exclusivity of the section 20(a) remedy in either the language of section 10(b) or the structure of the 1934 Act, proponents of exclusivity argue that because of the good faith defense, to allow *respondeat superior* liability, which imposes strict liability without a good faith defense, would undermine congressional intent. They argue that section 15's "controlling person" provision, enacted in 1933, was to provide the only form of secondary liability and when, in 1934, it was amended to include the "good faith" defense and section 20(a) was enacted containing the same defense, Congress clearly rejected the strict liability approach of *respondeat superior*.<sup>379</sup>

This argument is vulnerable on several grounds. First, remember from Part II(A)(2) that *respondeat superior* presents an elements of liability issue. Therefore, the fact that Congress rejected an insurer's standard of liability regarding the scope of conduct issue is "in reality not inconsistent with employing respondeat superior to resolve which party should bear the loss."<sup>380</sup>

Furthermore, if section 15 was not intended to be the sole form of secondary liability under the 1933 Act (or section 20(a) for the 1934 Act), but was instead meant to *expand* the available remedies beyond *respondeat superior*, then the whole premise of the exclusivity argument collapses. While the issue is close, the legislative history of section 20(a), like the language and structure of the provision, argues against exclusivity.

Most importantly, the legislative history seems to indicate that *respondeat superior* liability and controlling person liability are essentially aimed at different types of acts. According to the only Congressman who spoke on the subject during the debates leading to passage of section 20(a), its controlling person provisions were aimed at catching the person who stands behind the scenes and controls the person who is in a nominal position of authority.<sup>381</sup> This interpretation is consistent with the 1933 Act's section 15, which apparently was aimed largely at preventing the true directors of a corporation from evading liability by acting through "dummy directors."<sup>382</sup>

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<sup>378</sup> These amendments were made in response to criticism and industry lobbying in the wake of the passage of the 1933 Act. See Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007, 1009 (1983).

<sup>379</sup> See, e.g., Fischel, *supra* note 11, at 98-99.

<sup>380</sup> Gottesman, *supra* note 121, at 207.

<sup>381</sup> See 78 CONG. REC. 8095 (1934) (Congressman Lea); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1115 (5th Cir. 1980).

<sup>382</sup> See S. 875, 73d Cong., 1st Sess. Secs. 2(k), 4, 13 (1933); S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933); see also Paul F. Newton, 630 F.2d at 1115-16. The proposed Senate version of section 15 of the 1933 Act provided:

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It shall be unlawful for any person, firm, [or] corporation . . . to employ any "dummy" . . . or to engage in any transaction . . . relating to the interstate purchase or sale of any securities which operates as a fraud on the purchaser. The director or other person for whom any "dummy" shall act shall be held responsible under this Act for any unlawful conduct by such "dummy[.]"

S. 875, 73d Cong., 1st Sess. section 13 (1933), *reprinted in* 1 Federal Securities Laws—Legislative History 1933–1982, at 27, 82–83 (Federal Bar Ass'n Sec. L. Comm. ed., 1983).

As explained by Ferrara & Sanger, the explicit "dummy" language was deleted in conference committee. *See* Ferrara & Sanger, *supra* note 378, at 1008. Still, the wording of section 15 is consistent with such a purpose, and no other purpose seems readily apparent. *See also* SEC's *Kamen* Brief, *supra* note 316, at 13–14 (quoted in Ruder, *supra* note 316, at 606 n.37):

The legislative history of the controlling-persons provisions supports this analysis of their precise focus. The original Senate version of the 1933 Act contained a number of provisions designed "to aid in preventing directors from evading the liabilities incident to signing the registration statement\*\*\*." This draft of the Act dealt with the use of a "dummy" signer of a registration statement and made the fraudulent use of a "dummy" unlawful. The House version, which contained registration and antifraud provisions very much like those eventually adopted, contained no sections expressly dealing either with "dummies" or with controlling persons. In conference these "'dummy' provisions, which were calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by one party over the other \*\*\* [were] welded into one and incorporated as a new section in the substitute." The "new section" is what is now the controlling-persons provision of Section 15. Thus, that section was the result of congressional concern with the special problem presented by the use of "dummies", and was not designed to govern the usual employment situation.

During the debate, the following exchange occurred:

Mr. LEA of California. The object of this provision is to catch the man who stands behind the scenes and controls the man who is in a nominal position of authority. The man in control is just as well known as a dummy on a directorate. If a case went into court, of course, it would be necessary to establish the charge of control by the evidence . . . .

Mr. HOLLISTER. Would not an ordinary agency provision cover that? A man is either an agent or he is not an agent.

Mr. LEA of California. There would be no contractual relation, necessarily. It is just the same position as in the control of a dummy on a directorate. The man who stands behind the scenes and dominates the dummy ought to be responsible because he is the real party in interest.

78 CONG. REC. 8095 (1934) (House debate).

In counterargument, Fitzpatrick and Carman contend:

Upon closer examination it appears that these remarks [made during legislative debates] were primarily addressed to section 20(b), not 20(a). When referring to the two sections, the report of the Committee on Interstate Commerce stated that section 20(a) makes “a person who controls a person . . . liable to the same extent as the person controlled unless the controlling person acted in good faith and did not induce the act in question,” while section 20(b) “makes it unlawful for any person to do, through any other person, anything that he is forbidden to do himself.” It appears then that Exchange Act section 20(b), not 20(a), was specifically aimed at the “dummy” situation.<sup>383</sup>

The fatal flaw in this argument is that all the “dummy” references in the legislative history of the 1933 Act were to section 15. Section 15’s analogue is section 20(a). Section 20(a) was drawn nearly verbatim from section 15 and was adopted for exactly the same reasons as section 15.<sup>384</sup> There is no section 20(b) parallel provision in section 15. Section 20(b) remains a mysterious provision that, although it has been seldom invoked,<sup>385</sup> seems on its face to contradict any claim that section 20(a) provides the only form of secondary

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The House Report indicates that the “dummy provisions” of section 15 were “calculated to place liability upon a person who acted through another, irrespective of whether a direct agency relationship existed but dependent upon the actual control exercised by the one party over the other.” H.R. REP. NO. 152 at 27 (1933). *See also* Letter from James M. Landis, Commissioner of the F.T.C., to Senator Duncan Fletcher, Chair of the Senate Banking and Currency Committee (May 2, 1934), *reprinted in* 78 CONG. REC. 8717 (1934), stating: “According to the Bar Association report, the proposed changes which are made in section 15 are intended to make that section applicable only to prevent the use of dummies in order to evade liability.”

*See generally* Carson, *supra* note 291, at 271 (explaining “dummy director” phenomenon and Congress’s response to it); Note, *Legislation—The Securities Act of 1933*, 33 COLUM. L. REV. 1220, 1230 (1933) (concluding that section 15 was passed to abolish “dummy” directors “and [that] the scheme of business organization based on control without responsibility [will be] severely shaken.”).

<sup>383</sup> Fitzpatrick & Carman, *supra* note 7, at 26. Section 20(b) provides: “It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this [title] or any rule or regulation thereunder through or by means of any other person.” 15 U.S.C. § 78t(b) (1981).

<sup>384</sup> “[Section 20(a)] is taken verbatim from the Securities Act. The purpose is to prevent evasion of the provisions of the section by organizing dummies who will undertake the actual things forbidden by the section.” *Stock Exchange Practices: Hearing on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), Before the Senate Comm. on Banking and Currency*, 73d Cong. 6571 (1934) (Statement of Thomas G. Corcoran).

<sup>385</sup> *See* Cohen v. Citibank, 954 F. Supp. 621, 630 (S.D.N.Y. 1996) (“Few reported cases discuss the applicability of Section 20(b) . . .”).

liability. Indeed, section 20(b) can plausibly be read to authorize imposition of *respondeat superior* liability, although no court has so held.<sup>386</sup>

It appears that in drafting section 15 and section 20(a), Congress was not even thinking about the liability of employers for their employees.<sup>387</sup> Corporations, accounting firms, and law firms do not “stand in the shadows” manipulating their agents. They do not act through “dummies.” The investing public rightfully expects corporations and firms to answer for the torts of their agents irrespective of the existence of section 20(a). Rather, in enacting section 20(a), Congress was trying to extend liability beyond the master-servant relationship, where *respondeat superior* liability already universally applied, in order to reach additional, hidden malefactors.

As Professor Conard has explained,<sup>388</sup> this extension of liability was necessary because the common law at the time could not reach those behind the scenes unless they had provided grounds for piercing the corporate veil<sup>389</sup> or had personally participated in the fraud.<sup>390</sup> The former doctrine was only in its formative stages at the time and typically allowed piercing only where the wrongdoing entity was no more than a mere sham.<sup>391</sup> Section 15 was enacted

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<sup>386</sup> See Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward An Improved Analysis*, 126 U. PA. L. REV. 1345, 1351 (1978) (“Moreover, the potential sufficiency of section 20(b) of the 1934 Act as a vehicle to serve the rule of *respondeat superior* has apparently been ignored.”).

<sup>387</sup> See generally Alfred F. Conard, *Control, Responsibility, and Abdication: A Dilemma of Securities Regulation*, 17 J. CORP. L. 539, 551–53 (1992) [hereinafter Conard, *Control*] (reviewing legislative history and noting that Congress probably did not have in mind the employer-employee relationship in enacting the various control provisions of the 1933 and 1934 Acts); Conard, *Enterprise Liability*, *supra* note 179, at 919–20 (same); Levin, *supra* note 7, at 622–26 (same).

<sup>388</sup> See Conard, *Enterprise Liability*, *supra* note 179, at 920–21.

<sup>389</sup> See SEC Kamen Brief, *supra* note 316, at 12. As Professor Conard has put it, “[w]hen the New Deal lawmakers adopted a program of ‘truth in securities,’ they were determined to prevent the officers and directors, the major shareholders, the financiers, and other dominant figures, from shielding their frauds behind the barrier of corporate entity.” Conard, *Control*, *supra* note 387, at 541–42.

<sup>390</sup> At common law, for example, directors and officers were not liable on an agency basis for the torts of other officers and directors unless they participated in the fraud themselves. See, e.g., *Rives v. Bartlett*, 109 N.E. 83, 83–85 (N.Y. 1915). If they did so participate, naturally they would be held liable. See, e.g., *Powers v. American Traffic Signal Corp.*, 209 N.W. 16, 16–17 (Minn. 1926) (whoever participates in a fraud is liable); *Orlann v. Laederich*, 92 S.W.2d 190, 194 (Mo. 1936) (“Any one or more of several persons participating in the perpetration of an actionable fraud becomes a fraud-feasor, and . . . is liable.”).

<sup>391</sup> See Conard, *Control*, *supra* note 387, at 552 (“[T]he case law of the time provided no basis for [piercing the corporate veil] as long as the malefactor was more than a mere

to change this situation by expanding liability to those not reached by *respondeat superior*.<sup>392</sup> Section 15, it was said at the time, “almost completely voids the effect of the corporate entity as a nonconductor.”<sup>393</sup>

Section 20(a) was enacted for the same reason. In addition to “dummy directors,” section 20(a) allows plaintiffs to reach stock exchanges for the acts of brokerage houses they have registered;<sup>394</sup> brokerage firms for the acts of non-agent correspondent brokers<sup>395</sup> and investment advisers on the firm’s approved list;<sup>396</sup> corporations for certain acts of their employees apparently outside the scope of employment;<sup>397</sup> brokerage firms for their employees’ misappropriation of clients’ funds under circumstances that appeared clearly beyond the scope of their employment;<sup>398</sup> and directors and officers for the torts of other managers in which they did not participate<sup>399</sup> and in situations where they would not have been viewed as principals in a master-servant relationship.<sup>400</sup> Section 20(a) could also allow plaintiffs to reach defendants that control wrongdoers through holding companies, by family connections, or in

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sham.”).

<sup>392</sup> See George J. Feldman, *The New Federal Securities Act*, 14 BOSTON U. L. REV. 1, 12–13 (1934) (noting that it “destroys to a considerable extent the utility of the holding company device”). *Id.* at 13.

<sup>393</sup> *Id.* at 12–13.

<sup>394</sup> See, e.g., *Hughes v. Dempsey-Tegeler & Co.*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,133 at 94,540 (C.D. Cal. Sept. 4, 1973), *aff’d*, 534 F.2d 156 (9th Cir. 1976).

<sup>395</sup> See Levin, *supra* note 7, at 631–32. A strong argument has also been made that although agency liability did not attach to a brokerage firm in *Sennott v. Rodman & Renshaw*, 474 F.2d 32 (7th Cir. 1973), because plaintiff was attempting to buy what turned out to be nonexistent options by dealing with a particular employee outside normal firm channels, controlling person liability should have been imposed. See Gottesman, *supra* note 121, at 189–90 (arguing that “control” definitely existed and the firm’s alleged good faith was questionable).

<sup>396</sup> See, e.g., *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 538–39 (D. Md. 1978).

<sup>397</sup> See, e.g., *Gordon v. Burr*, 366 F. Supp. 156, 169–70 (S.D.N.Y. 1973) (dicta), *aff’d in part, rev’d in part* 506 F.2d 1080 (2d Cir. 1974).

<sup>398</sup> See, e.g., *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 875–76 (7th Cir. 1992) (plaintiffs sent funds directly to broker); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc) (same).

<sup>399</sup> See, e.g., *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957–58 (5th Cir. 1981); *Holmes v. Bateson*, 583 F.2d 542, 560 (1st Cir. 1978); *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 274–76 (10th Cir. 1957) (applying section 15); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff’d on other grounds* 422 F.2d 871 (2d Cir. 1970).

<sup>400</sup> See, e.g., *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 959 (5th Cir. 1981).

other nonagency ways.<sup>401</sup> Controlling shareholders could be reached in situations where piercing the corporate veil was not available.<sup>402</sup>

In other words, *respondeat superior* already governed the responsibility of principals for their agents. Congress was well aware of the fact<sup>403</sup> and would not have given it another thought.<sup>404</sup> The controlling person liability provisions of the 1933 and 1934 Acts were aimed primarily at situations of control over firms (and others) by behind-the-scenes actors.<sup>405</sup> To repeat, enactment of the controlling person provisions of the 1933 and 1934 Acts “was motivated by a fear that traditional theories of secondary liability, such as agency, would not prove adequate, in every case, to extend liability to those who were ‘really responsible’ for violations of the securities laws.”<sup>406</sup> Those, like Professor Fischel, who argue that section 20(a) renders agency liability theories “mere surplusage” assume a coextensiveness of the two categories that simply does not exist.

It seems unlikely that Congress would have attempted to effectuate its purpose of increasing investor protection by passing a statute that provided in almost all situations less rather than more protection. As Justice Breyer wrote when he sat on the First Circuit: “Though the relevant written history [of section 20(a)] is sparse, it is significant, for it makes clear that the section was

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<sup>401</sup> See IX LOSS & SELIGMAN, *supra* note 201, at 4476. Other nonagency methods of control have been suggested as well. See Gottesman, *supra* note 121, at 202 n.93 (“[A] creditor holding a substantial amount of pledged stock, a majority shareholder, a ‘dummy’ corporation, or a former employee whose opinions are valued greatly and followed, might be considered a control person, without there being an agency relationship.”).

<sup>402</sup> See, e.g., *Whittaker v. Wall*, 226 F.2d 868, 871–72 (8th Cir. 1955) (substantial shareholder and president); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875, 879 (2d Cir. 1943) (sole shareholder).

<sup>403</sup> See *supra* note 2. As noted in the introduction, during the hearings a key witness carefully explained to the House Committee that “it is a principle that runs all through the law that we are responsible for the acts of our agents.” *Federal Securities Act Hearings*, *supra* note 1, at 122 (statement of Ollie N. Butler, Dept. of Commerce).

<sup>404</sup> Conard, *Enterprise Liability*, *supra* note 179, at 921 (footnote omitted):

[T]he liability of employers, unlike that of officers, directors, and shareholders, had long been established in both state and federal courts. If legislators or their scriveners gave any thought to the liability of employers for securities frauds, they would naturally have expected courts to apply enterprise liability [*respondeat superior*] to securities frauds as courts had done in other fraud cases.

<sup>405</sup> See Conard, *Control*, *supra* note 387, at 551–53 (“[T]he legislators of 1933 and 1934 designed their control provisions to address the control exercised by holding companies, major shareholders, financiers, and others over corporations that issue securities.”).

<sup>406</sup> Levin, *supra* note 7, at 626.

aimed at expanding liability, rather than contracting it.”<sup>407</sup>

Professor Musewicz has demonstrated that the legislative history shows that one of the few representatives to comment specifically upon section 20(a), Representative Hollister, argued that it was too broad and should be deleted from the bill as an undefinable extension of common agency law principles: “It would be a strange and unexpected result if opponents of section 20(a), who sought its deletion because of their view that section 20(a) expanded secondary liability, discovered that in fact their fellow legislators were limiting secondary liability.”<sup>408</sup>

In the hearings over the 1933 Act, there was much concern expressed that individual directors’ liability be minimized,<sup>409</sup> but none that corporate *respondeat superior* liability be minimized. Elimination of *respondeat superior* liability would have been a big deal. Surely somewhere in the legislative debates there would have been some note taken of this sea change in the law. Before *Central Bank*, lower courts had taken just this argument, applied it to the differing facts regarding the origins and status of *respondeat superior* liability, and held that “given the pervasive applicability of agency principles elsewhere in the law, it would take clear evidence to persuade us that Congress intended to supplant such principles by enacting the ‘controlling person’ provisions.”<sup>410</sup> It makes much more sense to conclude that the good faith defense of section 20(a) was included as a way of buffering a new extension of liability beyond what had existed before.

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<sup>407</sup> *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 33 (1st Cir. 1986); see also *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980) (concluding that the 1934 Act’s legislative history does not reflect any congressional intent to restrict secondary liability for violations of the Act to the control person formula of section 20(a)); SEC *Kamen* Brief, *supra* note 316, at 12–13 (Section 20(a) was passed to extend investor protection by “reach[ing] situations in which there are technical barriers between the persons in fact responsible for violations of the securities acts and those injured by the violations . . .”).

<sup>408</sup> Musewicz, *supra* note 7, at 787.

<sup>409</sup> See *Federal Securities Act Hearings*, *supra* note 1, at 15 (Statement of Representative Parker). Furthermore, when the representatives debated the bill that enacted section 20(a), they seemed to presume the viability of agency principles. See Musewicz, *supra* note 7, at 786–87 (one of the few explicit exchanges regarding controlling person liability—between Representatives Hollister and Lea—seemed to presume continued existence of agency liability).

<sup>410</sup> *S.E.C. v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).

## D. Policy Considerations

### 1. Certainty and Predictability

As noted earlier, changing a long-established and nearly unanimous rule of law by making section 20(a) the exclusive form of secondary liability under section 10(b) and Rule 10b-5 does little to aid certainty and predictability of the law. To the extent that clarity is a related policy consideration, "controlling person" jurisprudence is just as confusing as the jurisprudence of aiding and abetting about which the Supreme Court complained in *Central Bank*.<sup>411</sup> Indeed, few areas of federal securities law are more confusing than "controlling person" jurisprudence.<sup>412</sup> Thus, exclusive reliance on this section 20(a) for imposition of secondary liability under the 1934 Act will do little to advance the cause of certainty, predictability, or clarity.

### 2. Litigiousness

Recognizing vicarious section 10(b) and Rule 10b-5 liability under *respondeat superior* will encourage more defrauded plaintiffs to seek compensation for their losses than would a regime consisting solely of "controlling person" secondary liability. To that extent, such recognition encourages litigation. Although the current majority of the Supreme Court may

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<sup>411</sup> See, e.g., Ferrara & Sanger, *supra* note 378, at 1010 (discussing varying views regarding who is a "controlling person").

<sup>412</sup> See A.A. Sommer, Jr., *Who's "In Control"?*—S.E.C., 21 BUS. LAW. 559, 563 (1966):

Alas, [certainty and precision are] rarely the case with key concepts in the structure of federal securities law, and this is particularly true in the case of the concept of "control". Like so many key notions the imprecise limits of the term have been limned through the pain-staking process of rule, interpretation, judicial decision and ad hoc determinations in "no action letters". Out of these there has come no mathematical standard, no slide rule computation, no certain rule which can infallibly guide counsel and client in making this most important determination—a determination which can be costly if wrongly made.

See also Carson, *supra* note 291, at 266 ("[A] great deal of uncertainty surrounds the scope and proper application of the [controlling person provisions] more than sixty years after their enactment."); Comment, *Secondary Liability of Controlling Persons Under the Securities Acts: Toward an Improved Analysis*, 126 U. PA. L. REV. 1345, 1346 (1978) (stating that section 20(a) "is plagued by vague holdings, questionable statutory interpretation, and disregarded distinctions.").



disagree, given the 1934 Congress's strong intent to compensate defrauded investors for their losses, more litigation is not necessarily a bad development. Less litigation means less deterrence, which translates into more violations and more investor losses<sup>413</sup> of the type Congress meant to prevent when it passed the 1934 Act.

To the extent that the cost of litigation is the Court's concern, the strict liability feature of *respondeat superior* should produce cheaper litigation than the controlling person provision, which requires litigation of the controlling person's state of mind.<sup>414</sup>

### 3. *Compensating Defrauded Investors*

#### a. *Burden of Proof*

The "good faith" defense of section 20(a) arguably encourages defendants, such as brokerage firms, to maximize "cosmetic value" rather than the actual effectiveness of their controls.<sup>415</sup> In terms of prevention as well, there is a distinct difference between an incentive to make it appear that one tried hard and an incentive to actually get the job done. Any conclusion that section 20(a) is exclusive "would in effect give blessing to a hear-no-evil, see-no-evil approach"<sup>416</sup> by defendant firms.

The problem is magnified in jurisdictions that require plaintiffs to prove the controlling person's intentional participation as a prerequisite to imposing liability under section 20(a):

Congress provided investors a cause of action for losses caused by fraudulent activities to restore investor confidence in the integrity and stability of the securities markets. Requiring proof that the controlling person orchestrated or intentionally furthered the fraud imposes an evidentiary burden virtually impossible to satisfy. In most cases the investor deals exclusively with the

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<sup>413</sup> See Conard, *Enterprise Liability*, *supra* note 179, at 952 ("If fewer employers are liable, the number of suits filed will probably diminish. While litigation expenses fall, deterrence will also diminish, and the frequency of violations and resulting losses will increase.").

<sup>414</sup> On the other hand, the strict liability approach may encourage more litigation and to that extent increase litigation costs overall. See Verkerke, *supra* note 94, at 312.

<sup>415</sup> See Seiter, *supra* note 7, at 1534 (making the additional point that "[r]espondeat superior is actually more fair to truly well-run firms, because although firms are held liable without fault for employee fraud, their aggregate judgment costs will presumably be lower the more carefully they actually supervise their employees.").

<sup>416</sup> *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968), *aff'd in part and rev'd in part* 422 F.2d 124 (4th Cir. 1970) (referring to section 15 of the 1933 Act).

controlled person and will not have met or even dealt indirectly with the controlling person. As a result, it is difficult for an investor to uncover proof that the controlling person *intended* to defraud her, and proof that the controlling person only knew of the fraud will be insufficient to impose liability. Requiring proof of intentional participation, therefore, effectively shields a controlling person from liability and prevents investors from recovering losses.<sup>417</sup>

#### b. *Ensuring Compensation*

To the extent that compensating defrauded investors is one of the purposes of the federal securities laws, the most expeditious course is to provide for both *respondeat superior* and controlling person liability.<sup>418</sup> More deep pockets mean more compensation for defrauded investors.<sup>419</sup>

### 4. *Deterring Fraud*

In terms of the policies underlying investor protection, controlling person liability is certainly superior to a system of no secondary liability whatsoever, but it is demonstrably inferior to a regime that includes *respondeat superior* liability as well.

Whether *respondeat superior* or controlling person liability is applied, the prudent employer must decide how much in the way of resources to devote to minimizing employer wrongdoing. That decision will arguably be affected by the employer's level of liability, and it intuitively seems that the employer would devote more effort and resources under a controlling person regime than under a system of no vicarious liability whatsoever, but less than under a *respondeat superior* regime.<sup>420</sup> Furthermore, *respondeat superior* gives employers the incentive to choose and supervise carefully, whereas

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<sup>417</sup> Staudt, *supra* note 40, at 950–52 (footnotes omitted).

<sup>418</sup> See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990) (en banc) (“Only if both *respondeat superior* and § 20(a) are available is the statutory scheme comprehensive and the public protected by the federal securities laws.”).

<sup>419</sup> See generally *supra* notes 269–73 and accompanying text.

<sup>420</sup> See Conard, *Enterprise Liability*, *supra* note 179, at 947. However, this is not certain, because an argument can be made that similar precautions are taken under regimes of strict liability (*respondeat superior*) and negligence (controlling person). See Steve Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 1–25 (1980). Conard, however, further argues that this traditional rationale in favor of *respondeat superior* liability has even more force in the securities industry than in the personal injury cases from which it arose because “employers and employees alike in the securities industry have economic incentives to commit the offenses. A vigorous desire of employers to eliminate violations is essential to deterrence.” Conard, *Enterprise Liability*, *supra* note 179, at 948.

nonprincipal defendants in section 20(a) cases often neither hire nor supervise the wrongdoing agents.<sup>421</sup> Thus, the incentive is wasted on them.

### 5. Advancing Market Efficiency

Again, a controlling person system of liability is likely more efficient than a system of no enterprise liability, but probably less efficient than a system of *respondeat superior*. For securities firms to be allowed to advertise their reputation and then hide behind the “hear-no-evil, see-no-evil” defenses of section 20(a) radically undermines the integrity of the securities industry<sup>422</sup> and the public’s confidence in it. The arguments from Part II(E)(2)(c) need not be repeated here.

Furthermore, to the extent that *respondeat superior* contributes to efficiency by spreading the risk, principals are typically employers that can spread the risk, as noted above. Controlling persons are typically not employers and will be less likely to be able to spread the risk.<sup>423</sup>

## IV. CONCLUSION

*Respondeat superior* is a foundational principle of tort law and is ubiquitous in Western legal systems. It seems surpassingly odd that out of the entire American legal system *respondeat superior* liability under section 10(b), and only under section 10(b), should be targeted and eliminated. Yet, Justice Stevens and the commentators agree, that is the result compelled by the logic of the *Central Bank* majority opinion. Regrettably, some courts are already implementing this logic.

This Article demonstrates that a closer examination of the statutory language, the structural scheme, the legislative history, and the policies underlying the 1934 Act in general and section 10(b) specifically indicates that *respondeat superior* liability, a fixture of all realms of federal securities law, including section 10(b) for sixty years, should remain available in such actions.

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<sup>421</sup> See, e.g., Seiter, *supra* note 7, at 1535–36.

<sup>422</sup> See Note, *Vicarious Liability for Securities Law Violations: Respondeat Superior and the Controlling Person Sections*, 15 WM. & MARY L. REV. 713, 719 (1974) (citing *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. 1165, 1212 (D. Md. 1968)).

<sup>423</sup> A reasonably strong argument has been made that Congress intended section 20(a) to apply only to individual defendants, leaving organizational defendants liable solely under *respondeat superior*. See Burns, *supra* note 294, at 1222 (“[C]ourts can eliminate the existing incongruity, comply with Congress’[s] original intent, and achieve the goal of increasing the protection provided to investors, by confining the application of the controlling person provisions to individuals while applying agency principles in their traditional manner.”). The SEC itself maintained this position until around 1982. *Id.* at 1208–09.

*Respondeat superior* is in many ways different than aiding and abetting, and the Supreme Court's elimination of the latter theory in *Central Bank* does not, in fact, compel elimination of the former. Analysis of the key factors—statutory language, structural scheme, legislative history, and policy—also demonstrates that section 20(a) controlling person liability should supplement, not supplant, *respondeat superior* liability in section 10(b) and Rule 10b-5 causes of action.

Vicarious liability, such as *respondeat superior*, is such a settled feature of American tort law that large corporations and accounting firms that have lobbied so vigorously and successfully for protective amendments to the federal securities laws, and to federal and state tort law in general, are not seeking elimination of *respondeat superior*.<sup>424</sup> It is simply unthinkable, even to these potential defendants, that a company would not be held liable under section 10(b) and Rule 10b-5 for fraudulent statements issued by employees in connection with the sale or purchase of securities or that an accounting firm would not be liable for the fraudulent acts of its auditors. Yet this is the result that must follow if *respondeat superior* liability is eliminated.

This state of affairs is so unthinkable that commentators have suggested that perhaps elimination of *respondeat superior* pursuant to *Central Bank* would not be so bad because courts might soften the blow by continuing to hold corporations liable for the actions of their top officials.<sup>425</sup> There is some precedent for this approach because some courts have imposed what they called “primary” liability upon companies acting through their top executives.<sup>426</sup>

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<sup>424</sup> See Schwartz, *supra* note 3, at 1744–45.

<sup>425</sup> See Langevoort, *supra* note 36, at 894 (citing *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), as an example of a case holding a corporation “primarily” liable for acts of its executives); Steinberg, *supra* note 14, at 502 (claiming that a corporation may be held primarily liable when its executive officers act improperly).

<sup>426</sup> *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), is the leading case for this proposition. However, upon reflection it should be clear that even where a company's CEO or Chairman of the Board or entire board of directors acts tortiously, the company's liability is secondary, being necessarily based on agency principles.

As authority for its position, the *Sharp* court cited *Holmes v. Bateson*, 583 F.2d 542 (1st Cir. 1978), apparently completely misapprehending its holding. *Sharp* cites *Bateson* as holding that when a company is liable because its top officers have committed fraud, this is primary liability as distinguished from *respondeat superior*'s secondary liability. What *Bateson* says is that when a corporation's “officers and employees,” *id.* at 560, commit a fraud, the company is liable. This interpretation is traditional *respondeat superior* theory, and it does not matter whether the malfeasors are top officials or not. The *Bateson* court used the term “primary liability” loosely, just to indicate that although a corporation may have a right of indemnity against the wrongdoing employee, it “cannot escape its primary liability to the party defrauded.” *Id.* at 561. In other words, the *Bateson* court did not use the term “primary” meaning to contrast it to “secondary” liability. Its reasoning is very clear that

Indeed, one of the lower court cases to hold that *respondeat superior* liability under section 10(b) and Rule 10b-5 was eliminated by *Central Bank* held, contradictorily, that for purposes of the “group pleading” doctrine, the corporate defendant was responsible for the fraudulent statements of one of its officers.<sup>427</sup> Even the Supreme Court in *Monell* refused to impose *respondeat superior* liability upon municipalities under section 1983 of the Civil Rights Act, yet concocted an artificial doctrine whereby such municipalities could nonetheless be held vicariously liable for the acts of their agents if those acts represented “official policy” stemming from someone with “final authority.”<sup>428</sup>

However, to simultaneously eliminate *respondeat superior* liability yet construct some sort of faux primary liability by pretending that holding a corporation liable for the acts of its upper level agents is not a form of vicarious liability is simply an anthropomorphizing delusion:

Corporations are a legal fiction representing a network of legal, usually contractual, arrangements. “Corporations” thus do not act, do not make contracts, sell property, or commit torts; their agents do. For convenience, we sometimes describe the acts of such agents as acts of the corporation. But if an agent commits a tort and the tort is said to have been committed by the corporation (meaning that damages will be paid out of the corporate treasury), the corporation’s liability is necessarily vicarious.<sup>429</sup>

Congress passed the 1934 Act against the background of a common law that imposed *respondeat superior* liability for the torts of all agents acting within the scope of authority, not just upper echelon agents.<sup>430</sup> Section 3(a)(9) of the

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“primary” liability was being imposed on the corporation through *respondeat superior*. Therefore, the *Sharp* court’s holding was a simple invention and clearly wrong.

<sup>427</sup> See *supra* note 66 and accompanying text.

<sup>428</sup> See *supra* notes 110–11 and accompanying text.

<sup>429</sup> Kramer & Sykes, *supra* note 109, at 249; see also Sharon Tompkins, Note, *Tightening Gatekeeper Liability: Should Officers’ and Directors’ Wrongdoing Be Imputed to the Corporation in Suits Against Third-Party Professionals?*, 69 S. CAL. L. REV. 1883, 1885 (1996) (“A corporation cannot have knowledge in any real sense because it cannot see, know, feel or think. It must derive its knowledge and intelligence from the eyes, ears, and brains of its agents.”).

<sup>430</sup> Even the criminal law imposes liability upon principals for the acts of lower level agents. See Kathleen F. Brickley, *Corporate Criminal Liability: A Primer for Corporate Counsel*, 40 BUS. LAW. 129, 131 (1984) (“A corporation may be held [criminally] liable for the acts of its agents without regard to their status in the corporate hierarchy.”) (footnotes omitted); Samuel R. Miller, *Corporate Criminal Liability: A Principle Extended to its Limits*, 38 FED. B.J. 49, 53 (1979) (“Courts have searched deep into the corporate hierarchy to pinpoint an employee whose criminal acts may be imputed to the company.”); Pitt & Groskaufmanis, *supra* note 282, at 1572 (“Even low-level, ‘menial’ employees can expose

1934 Act defines "person" to include "company," not "company, *but only if it acts through designated high-level officials*."<sup>431</sup>

To recognize a bastardized form of *respondeat superior* liability that imposes liability upon the principal only when the wrongdoing agents are top-level employees would not only be inconsistent with the common law that the 1934 Congress recognized and the definitional provisions it provided, but it would also invite the same sort of disaster that the Supreme Court created in *Monell* when it felt constrained to eliminate *respondeat superior* liability under section 1983. The Supreme Court could not stomach the result and had to devise the "final authority" test for liability, which was "strewn with obstacles not presented by respondeat superior,"<sup>432</sup> and further created a nightmare of

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their employers to criminal liability."); Michael E. Tigar, *It Does the Crime But Not the Time: Corporate Criminal Liability in Federal Law*, 17 AM. J. CRIM. L. 211, 212-27 (1990); Webb, *supra* note 300, at 623 ("Even the acts of the lowest-level employees may be imputed to the corporation, provided the acts occur within the scope of the employee's authority."); Weinstein & Ball, *supra* note 258, at 67 ("[E]ven where low level employees carry out intentional criminal acts on behalf of the corporate organization, courts have routinely attached corporate liability."); Kevin B. Huff, Note, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1253 (1996) ("Corporations are held liable even where lower-level employees commit crimes without the knowledge of upper management and contrary to express corporate policy or instructions."); Seth Maxwell, Note, *The Foreign Corrupt Practices Act and Other Arguments Against a Due Diligence Defense to Corporate Criminal Liability*, 29 UCLA L. REV. 447, 463 (1982) ("The federal courts have led the way in refusing to limit enterprise liability to the crimes committed by higher-echelon personnel.").

<sup>431</sup> There are cases that impute individual agents' intent to the firm only when those individuals are upper level employees. For example, in *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435-36 (9th Cir. 1995), the Ninth Circuit held that a corporation cannot be liable unless there is substantial scienter among its upper echelon agents. In so doing, the court created several problems. First, its ruling was inconsistent with traditional common law, which imputes the knowledge of all agents to the corporation. See Musewicz, *supra* note 7, at 764 n.79 ("Such analysis overlooks that ordinarily employees are, for most purposes, agents of their employers."). Second, the ruling provided no rationale for departing from the common law tradition, nor any clear guidelines for doing so. Should the courts draw the line at the board of directors? Officers? Supervisors? Third, the court did not justify giving the corporation a pass when its lower level employees commit securities fraud, but not when they commit other types of fraud or other torts such as assault and battery or careless driving. Fourth, the court seemed to be implying that a company's liability is secondary when it is based on the bad faith acts of lower-level employees, but that the company itself in some fashion acts with bad intent when its upper-level employees engage in fraud. This distinction is rooted in fantasy.

<sup>432</sup> Harold S. Lewis, Jr. & Theodore Y. Blumoff, *Reshaping Section 1983's Asymmetry*, 140 U. PA. L. REV. 755, 797 (1992).

confusion that is still not sorted out.<sup>433</sup>

Full-blown *respondeat superior* liability should attach in section 10(b) and Rule 10b-5 cases. Stock brokerage firms should be liable for the lies of their sales representatives. Accounting firms should be liable for the lies of their auditors. Corporations should be liable for the lies of their lower-level employees. Although many current Supreme Court members are clearly not thrilled that a cause of action was ever implied under section 10(b) and Rule 10b-5, this is now a *fait accompli*; it is not sensible to twist this cause of action so tortuously that it retains little or no utility.<sup>434</sup>

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<sup>433</sup> See generally George D. Brown, *Municipal Liability Under Section 1983 and the Ambiguities of Burger Court Federalism: A Comment on City of Oklahoma City v. Tuttle and Pembaur v. City of Cincinnati—The “Official Policy” Cases*, 27 B.C. L. REV. 883, 884 (1986) (citing Supreme Court’s decision to reject *respondeat superior* and impose a rule where municipalities are liable only for acts of employees when the acts involve “official policy” is, when operationalized, “a quicksand of uncertainty”); Kit Kinports, *The Buck Does Not Stop Here: Supervisory Liability in Section 1983 Cases*, 1997 U. ILL. L. REV. 147, 192 (stating that “inconsistencies . . . plague this area of the law . . .”); Kramer & Sykes, *supra* note 109, at 250 (“The policy rule has been extremely difficult to apply coherently, and there is no reason to continue the exercise.”); Lewis & Blumoff, *supra* note 432, at 790 (referring to “mischievous consequences” of the “policy” requirement); Comer, *supra* note 105, at 344 (noting that the Supreme “Court has been unable to reach [a] consensus on how the [final authority doctrine that it substituted for *respondeat superior*] should be applied”); David P. Strauss, Comment, *Vicarious Municipal Liability: Creating a Consistent Remedial Policy for Local Government Violations of Civil Rights*, 16 CAL. W. L. REV. 58, 86–87 (1980) (stating that *Monell* leaves citizens without adequate redress for the wrongs of governmental officials and draws lines between who will be compensated and who will not be compensated based on arbitrary and fortuitous grounds).

In its 1997 term, the Supreme Court had yet another opportunity to clarify *Monell* when it decided *Bryan County v. Brown*, 117 S. Ct. 1382 (Apr. 29, 1997). Unfortunately, its decision did not clarify the existing confusion, and four dissenters called for a complete re-examination of the Court’s approach to the problem, see Martin A. Schwartz, *Claims of Wrongful Hiring*, N.Y. L.J., June 17, 1997, at 3 (summarizing the various Justices’ views), and Professor Nahmod, author of a treatise on section 1983 litigation, was prompted to ask why the Court does “not go with a straight *respondeat superior* approach?” See Marcia Coyle, *High Court: Cities Get Wider Shield*, NAT’L L.J., May 12, 1997, at A10 (quoting Professor Nahmod).

<sup>434</sup> See Musewicz, *supra* note 7, at 777–78 (“Once the law admits of a remedy, its boundaries must be drawn reasonably, not arbitrarily.”).

